IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 134

PARAGON JEWEL COAL COMPANY, INC., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Tax Court (R. 189-225) is reported at 39 T.C. 257. The opinion of the court below (R. 252-255) is reported at 330 F. 2d 161.

JURISDICTION

The judgment of the court below (R. 256) was entered on March 17, 1964. The petition for a writ of certiorari was filed on June 1, 1964, and granted on October 12, 1964. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the decision below nullifies this Court's ruling in *Parsons* v. *Smith*, 359 U.S. 215, which held that the depletion deduction is available only to the owner of a capital interest in mineral in place.

2. The Tax Court found as facts that certain taxpayers, mining coal under contract with petitioner, lessee of the coal, (1) had no obligations under petitioner's coal leases and paid no royalties or taxes on the property or the mineral interest; (2) acquired no legal title either to the coal in place or to the coal after it was mined; (3) never acquired any interest in the coal by assignment or sublease from petitioner or by purchase or lease from anyone else; (4) sold none of the coal to anyone other than to the lessee and were not entitled to do so; (5) were not concerned with the sale price the lessee received for the coal; (6) mined only as directed by the lessee; and, on conflicting evidence, (7) had no right to mine any specific area to exhaustion.

The question presented is whether, having regard to the rule of *Parsons* v. *Smith*, 359 U.S. 215, where this Court declared that the depletion deduction was available only to the owner of a capital interest in mineral in place, the court below erred in holding that, on the foregoing facts, all of which were inconsistent with any ownership of or capital investment in the coal in place on the part of the contractors, they were none the less entitled to depletion on the footing that they shared an economic interest in the coal with the lessee, petitioner here.

3. Section 611(b)(1), I.R.C. 1954, continuing a provision in force since 1918, provides that, in the case of a lease, the deduction for depletion "shall be equit-

ably apportioned between the lessor and lessee." Section 631(c), I.R.C. 1954, denies the lessor of coal any deduction for depletion, and defines "owner" for the purpose of computing the depletion allowance as any person who owns an economic interest in coal in place, including a sublessor. Section 614(a), I.R.C. 1954, defines "property" for the purpose of computing the depletion allowance in the case of mines as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Section 631(b), I.R.C. 1954, defines an "owner" for the purpose of computing the depletion allowance as any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber.

The question presented is whether, in view of those provisions, there is any warrant in law for the holding below that a lessee of coal must share its depletion allowance with those with whom it has contracted to mine the coal and who plainly were not sublessees.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 1a-8a.

STATEMENT

The following facts were found by the Tax Court:

A. Paragon's leases and its mining contractors

Petitioner, Paragon Jewel Coal Company, Inc. (hereafter "Paragon"), acquired by assignment written leases on the coal in and underlying land in Buchanan County, Virginia. The leases required the lessee to mine either all or 85 per cent of the minable coal in and underlying the leased tracts. Paragon

assumed all the obligations of the lessees under the leases, and was obligated to pay annual minimum royalties, tonnage royalties, and land taxes. (R. 211.) The individuals specified below, who mined the coal under contracts with Paragon, did not assume any of Paragon's obligations under its leases and paid no royalties or taxes on the property or the mineral interest (R. 214) The contractors "acquired no legal title either to the coal in place or to the coal after it was mined" (R. 216).

After acquiring the leases, Paragon made substantial investments necessary for mining, processing and marketing the coal, including the construction and maintenance of a tipple, processing equipment, a power line, a railroad sidetrack with four spurs running under the tipple, and a road from the tipple around the mountain close to the outcrop line of the coal over which coal could be trucked from the mines to the tipple. Paragon did not mine the coal itself, but contracted out the mining to various individuals and firms who were to mine the coal at their own expense and deliver the coal to Paragon's tipple. Paragon would then clean and size the coal and sell it on the market. (R. 211-212.)

Among Paragon's independent contractors were Standard Smokeless Coal Company, whose partners during the period here in question were Robert Lee Merritt, G. Wesley Merritt, James O. Watson, and Jack D. Merritt (R. 212); Kyva Mining Company, a firm composed from time to time of G. Wesley Merritt, Watson and Virgil Bowling (R. 212); Farwest Coal Company, whose partners were Bowling and the three Merritts (R. 212-213), and certain other firms and individuals (R. 212-213).

The three Merritts, Watson, and Bowling, were petitioners in the consolidated proceeding in the Tax Court (R. 189, 190), and were similarly petitioners in the consolidated proceeding in the Fourth Circuit. As will be pointed out below, page 11, the cases of the Merritts and their fellow contractors have now once more been consolidated with Paragon's case in this Court.

B. Paragon's mining contracts

The contracts between Paragon and the several contractors above named were oral, and were performed as follows:

As Paragon extended its road around the side of the mountain, the prospective contractor would be taken to various proposed sites for mine openings, which Paragon would usually face up.[1] After the contractor selected a particular site, Paragon's representative would pick out the general area in which the contractor could mine. The contractor agreed to mine the coal in that area and to deliver it to Paragon's tipple at his own expense. The contractor was required to provide his own men and equipment, and, if necessary, to extend a road from Paragon's road to the mine portal. All expenses of opening and operating the mine were borne by the contractor. (R. 213-214.) The contractor agreed either to provide his own power or to purchase it from Paragon, and also agreed to pay Paragon for engineering services inside the mine rendered by Paragon's engineer (R. 214).

Paragon's engineer provided the contractor with a mine map showing the general direction in which the

[1] "Face up" means to remove the overburden of soil and to expose the seam of coal.

mine should progress, and showing where barriers between adjacent mines should be left so that one contractor did not break through into the mine of the adjacent contractor. The engineer extended the projection from time to time. Paragon insisted on all contractors using the same engineer, who could project a system for mining all the coal under its leases without leaving unrecovered pockets of coal and to prevent one contractor from breaking into the mine of another contractor. The contractors were required to obtain Paragon's permission before pulling pillars as they retreated from an area which had been mined. (R. 214-215.)

The contractors were not obligated to mine any specific amount of coal and were not specifically given the right to mine any particular area to exhaustion. The projections of the mines were based somewhat on the speed with which the contractor worked. If one contractor mined more rapidly, or if an adjacent mine ceased operating, he might be given the right to pierce the indicated barrier. (R. 215-216.)

C. Were the contracts terminable?

The Tax Court found (R. 215) that "The contracts were not made for any specific period of time and nothing was said about the right to terminate by either party at the time the agreements were entered into."

The record contains two exhibits (R. 231-246), both of which were sworn statements submitted by G. Wesley Merritt (one of the respondents in No. 237) to the District Director of Internal Revenue at Richmond, Va., one on behalf of the Kyva Mining Company, the other on behalf of Standard Smokeless Coal Company, the affiant plus his partners in the two firms compris-

ing all of the respondents in No. 237.[2] In each of these statements, which were sworn to and filed long before the present proceedings were commenced in the Tax Court, it was stated (R. 235, 243) that "The partnership's contract with Paragon embraced the following understanding between the partners and Paragon," listing nine lettered items, of which the last (R. 236, 244) was:

> "(i) The contract specified the right of termination by either party at any time, but the question never arose between the partnership and Paragon."

To continue with the Tax Court's findings:

Numerous contractors ceased mining from time to time as they were unable to mine coal profitably or for other reasons. Such contractors were not permitted to remove buildings from the premises but usually took their equipment with them unless it was under lien to Paragon. It was anticipated by both parties that a contractor would continue mining in the location assigned to him as long as the coal could be mined and sold at a profit and as long as the contractor employed proper mining methods and produced coal meeting Paragon's specifications. (R. 215.)

D. Other provisions of the contracts

Paragon agreed to pay the contractor a fixed price per ton for coal delivered to its tipple, less 2½ per cent for rejects. It was understood that the price might vary from time to time. The price paid by Paragon to the contractors did vary, depending somewhat on the general trend of market prices for the coal

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[2] Throughout this brief, all references to the respondents in No. 237 are to the contract miners, and do not include their respective wives, who were made parties only because they filed joint returns with their husbands.

over extended periods and to some lesser extent on labor costs. But price changes made by Paragon to the contractors were always prospective and the contractors were notified several days in advance of any price change so that they always knew the price they would get for coal when they delivered it to the tipple. The contractor had no further control over the coal after it was delivered to Paragon, and did not know how or for what price Paragon sold or otherwise disposed of the coal. (R. 214.)

During the years here involved, Paragon took all merchantable coal produced by the various contractors operating on Paragon's leased property and paid the contractors the price fixed by Paragon. Paragon sold very little of its coal under contract and the prices it obtained for coal varied quite frequently. If Paragon was unable to take all of the contractors' coal either because of lack of coal cars or because its tipple was full, the contractor would fill his own bins and then shut down until Paragon could take more coal. (R. 216.)

The contractors completed their obligations under the contracts by delivering the coal to Paragon's tipple and thereupon became entitled to their compensation for mining the coal by virtue of Paragon's personal covenant to pay them so much per ton. The contractors were not concerned with the sales price Paragon received for the coal. (R. 216.)

The contractors paid nothing for the privilege of mining coal other than their investment in equipment, roads, and buildings and their cost in opening the mine and mining the coal. They acquired no legal title either to the coal in place or to the coal after it was mined. The coal as delivered to Paragon's tipple by the contractors was not in a state which was salable to the consumer but had to be washed, graded, and treated

in order to be salable on the consumer market. All such processing was done by Paragon at its processing plant. The contractors sold none of the coal to anyone other than Paragon, and were not entitled to do so. (R. 216.)

E. The depletion issue in the Tax Court

Paragon claimed percentage depletion on its income tax returns for the taxable years ending September 30, 1955, 1956, and 1957. Standard Smokeless and Kyva claimed percentage depletion on their partnership returns for the calendar years 1954, 1955, and 1956. The Commissioner disallowed both sets of deductions, whereupon Paragon and the several partners in Standard Smokeless and Kyva separately filed petitions in the Tax Court contesting the resultant deficiencies. All the petitions were consolidated for hearing. (R. 189, 190, 217.)

The Commissioner took no position in the Tax Court on the depletion issue, the only one now remaining, beyond agreeing that either Paragon or the contractors were entitled to the depletion deduction, but not both (R. 32, 217).

The Tax Court held (R. 217-225) that, under the rule of *Parsons* v. *Smith,* 359 U.S. 215, Paragon alone was entitled to the depletion deduction. After making the findings outlined above, the Tax Court said in its opinion (R. 224), "While we cannot find that the right to terminate was specifically mentioned when the agreements were made, neither can we conclude that the agreements were nonterminable.

"On the facts in this case we conclude that the contractors could look only to the difference in their cost of mining the coal and the amount Paragon paid them for a return of their investment, that they made no

investment in and acquired no economic interest in the coal in place, and that consequently they are not entitled to depletion on the coal they produced." Decisions were entered accordingly (R. 225-230).

F. Proceedings and holding below: the parties' positions here

The contractors—the Merritts *et als.*—petitioned for review in the court below, but at that stage the Commissioner abandoned neutrality, and supported Paragon's sole right to the entire depletion allowance. He argued, *inter alia* (CIR Br. as Resp. 4-19), that the Tax Court correctly held that the Merritt group was not entitled to percentage depletion, and that the Tax Court's findings, which were not clearly erroneous, showed that the Merritt group made no investments in the coal in place that were necessarily reduced as the coal was extracted.

Nonetheless, in order to protect the revenue, the Commissioner filed a cross-petition to review the decision in favor of Paragon, urging his view (CIR Br. as Petr. 13-14) that "the Tax Court correctly decided this case," and stating that "in the argument below we will only outline briefly our reasons for believing the decision below is correct."

Even so, the court below reversed (R. 256). After substantially rewriting the terms of Paragon's oral agreement with its contractors as those terms had been found by the Tax Court (cf. R. 215-216 and 222-223 with R. 255), the Fourth Circuit concluded (R. 255) that "the operators had a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price. By virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest

in the mineral which brings them within the rationale of *Parsons* v. *Smith*, 359 U.S. 215 * * *."

Paragon petitioned for a writ of certiorari here, asserting that the Fourth Circuit had completely set aside *Parsons* v. *Smith*; the Commissioner, pointing out that *Parsons* v. *Smith* "presented the same issue on substantially similar facts," argued that "the decision of the court of appeals is basically in conflict with *Parsons*," but opposed review "despite the clear error of the decision below" (Memo. Op. 2, 3). On further consideration however, the Commissioner became "persuaded that the question is of sufficient dignity to warrant this Court's attention and that a judicial reversal of the decision below would provide the only wholly satisfactory solution to the problems of administration created by it"; he accordingly joined with Paragon in urging that the petition be granted (Resp. Supp. Memo. 2, 4-5).

Meanwhile the Commissioner had filed a petition to review the judgment below in favor of the Merritts *et als.* "in order to protect the government's interest should Paragon ultimately prevail" (Pet. 4, No. 237), asking therein that his petition be granted if Paragon's were. When certiorari was granted in Paragon's case without action on the cross-petition (R. 257), the Commissioner pointed out that since he agreed with Paragon that the court of appeals' decision was wrong, it would be necessary to grant his petition against the Merritts in order to bring them before the Court, and thus to make the proceeding one that was adversary in fact (Pet. Supp. Memo., No. 237).

Accordingly, the Court granted the Commissioner's petition, and consolidated both cases for argument (R. 258).

SUMMARY OF ARGUMENT

I.A. From *United States* v. *Ludey*, 274 U.S. 295, through *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, this Court has repeatedly ruled that the purpose of the deduction for depletion is to compensate the owner of wasting mineral assets for the part used up in production, so that when the minerals are exhausted, the owner's capital and his capital assets are unimpaired. The emphasis throughout has been on ownership, notably in the very similar recent use of *Parsons* v. *Smith*, 359 U.S. 215, where the deduction for depletion was, as here, claimed by parties who had contracts to mine coal, but who could not point to any capital investment in, or surrender to them of capital interest in, the coal in the ground.

B. In the first case where, under the apportionment provision that without substantial change is now § 611 (b)(1) of the 1954 Code, the Court granted a share of the depletion deduction to parties who were neither lessees or lessors, on the footing that they had an economic interest in the unextracted oil, the concept of "economic interest" was qualified and limited by the requirement that it must represent a capital investment in the oil in place. *Palmer* v. *Bender*, 287 U.S. 551. "Ownership was essential" (*Thomas* v. *Perkins*, 301 U.S. 655, 661), and the language of all subsequent decisions has emphasized the requirement of capital investment.

C. Thereafter "economic interest" was defined as excluding "a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit * * * which suffered depletion" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362), and that differentiation, between an economic interest acquired by making a capital investment in the mineral in the

ground, and a mere economic advantage arising out of a contract to extract that mineral, was promptly carried into the Treasury Regulations, where it still remains, substantially *in haec verba.* Income Tax Regulations under I.R.C. 1954, § 1.611-1(b)(1).

D. Later cases here, however, involving instances of fractionalized oil and gas interests, were read elsewhere as blurring the foregoing concept of "economic interest," and in *Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308, depletion was allowed to the owner of an upland tract, the use of which was indispensible to a drilling operation, even though the upland tract contained no oil. If that case is limited to its facts, it does not help the contractors here, and of course the Court need not reexamine its holding. Contrariwise, the present petitioner feels bound to do so. Careful analysis indicates that *Southwest Exploration* is inconsistent with both earlier and later cases, because it allowed depletion to parties whose capital assets were neither impaired nor exhausted by the drilling process, and who owned just as much oil at the beginning as at the close of the operation, viz., none whatever. Analysis also shows that in *Southwest Exploration* there was nothing to indicate a surrender to the upland owners of any capital interest in the oil in the ground. It was this insistence on a surrender of capital interest that led to the doctrinally different result in *Parsons* v. *Smith,* 359 U.S. 215, where the Court reemphasized the principle that depletion was intended "to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset."

E. In any event, the coal cases are far less complicated, because ownership of coal cannot be subdivided to the same extent as in oil and gas. There are only four possibilities: (1) ownership in fee of the land; (2) ownership in fee of the coal, separate from the

surface; (3) lease of the fee including the coal; (4) lease of the underlying coal only. Each of these interests represents a capital investment in the coal in place, and each of these interests can only be transferred or surrendered by an appropriate conveyance or contract to convey. Consequently a party who simply contracts to mine the coal represented by the foregoing interests does not thereby acquire any capital investment in the unmined coal.

F. In view of the controlling principle, reaffirmed and restated in *Parsons* v. *Smith*, 359 U.S. 215, that only the owner of a capital investment in the coal in the ground is entitled to the deduction for depletion, since it is his assets alone that become exhausted in the mining process, the terms of the contracts he makes for mining the coal are meaningful only for the light they throw on the issue of ownership. They have no independent significance, and it is a source of error to consider that they do. All of the factors canvassed in *Parsons* v. *Smith* to show that the contractors there had no capital investment in the unmined coal are considered, and the irrelevance of the right to mine to exhaustion, which though an issue in that case was not discussed in that opinion, is demonstrated. After all, a contract to cut another's grass in perpetuity does not provest in the man who pushes the lawnmower any proprietary interest in the other party's front yard.

II. Legislation enacted after the tax years considered in *Parsons* v. *Smith*, and which governs the tax years involved in the present case, demonstrates even more clearly than was earlier possible that coal contractors have no right whatever to any deduction for depletion.

A. Sec. 614(a) of the 1954 Code, giving statutory force to an earlier Treasury Regulation, defines "property" for purposes of depletion as "each separate interest owned by the taxpayer in each mineral deposit

in each separate tract or parcel of land." To ask what separate interest, &c., is owned by any coal contractor requires the obvious answer, None; coal contractors have no ownership of the coal either before or after the mining operation.

B. Since 1951, under § 631(c) of the 1954 Code and its predecessor provisions, the lessor of coal lands has been granted capital gains treatment for his royalties but in return has been denied any deduction for depletion. It follows that the provision for apportioning that deduction in the case of leases, now § 611(b)(1), no longer applies to coal leases. Consequently the entire deduction for depletion in the case of coal leases is now granted indivisibly to the lessee, and there remains no basis for any contention that one who simply contracts to mine coal belonging to another has any right to that deduction. After all, the deduction for depletion is a matter of legislative grace, and the coal contractor can point to nothing in the Code to show that Congress has granted him any part thereof.

C. The foregoing analysis is emphasized by the divergence between successive subsections of the present Code. Sec. 631(b), dealing with timber, defines "owner" as "any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber." But § 631(c), which dealt with coal during the tax years now in question, defined "owner" as "any person who owns an economic interest in coal in place, including a sublessor." And, when Congress in 1964 amended § 631(c) to include domestic iron ore, it continued the definition of ownership in the case of coal or iron ore as "any person who owns an economic interest in coal or iron ore in place," and significantly did not include in that definition the holder of a contract to mine coal or iron ore. Hence Congress once more enacted the words "economic interest" in the

restricted and limited sense in which they were first expounded by this Court and carried into the Treasury Regulations, and in the same restricted and limited sense in which the concept of economic interest was restated and reaffirmed in *Parsons* v. *Smith*.

III. A. The decision under review disregarded *Parsons* v. *Smith*, 359 U.S. 215, and the Court's emphasis there on ownership representing a capital investment in the mineral in the ground as the criterion of entitlement to the deduction for depletion.

That disregard is demonstrated in detail by considering the seven factors enumerated by the Court in *Parsons*, 359 U.S. at 225, as negativing the fictitious assertion made by the contractors there that they had somehow, through their contracts and their expenditures thereunder, acquired an economic interest that represented a capital investment in the unmined coal. Six of those seven factors, described in detail, are clearly present in this case.

While the Tax Court here could not say that the contracts in this case were nonterminable, its failure to find that they were in fact terminable was clearly erroneous, since such failure disregarded sworn *ante motam litem* statements filed with the Internal Revenue Service on behalf of all the contractors here, affidavits stating that "The contract specified the right of termination by either party at any time, but the question has never arisen between the partners and Paragon" (R. 236, 244).

This case also reflects a further factor not present in *Parsons*, namely, Paragon's detailed and rigid control over its contractors' mining operations, a control consistent only with its own complete property in the unmined coal, a control completely inconsistent with any property or capital or ownership interest what-

ever on the part of the contractors in such unmined coal.

B. The decision under review likewise disregarded the applicable provisions of the 1954 Internal Revenue Code and its implementing regulations. Indeed, the opinion below, although undertaking to allocate a deduction resting on legislative grace, did not even cite, much less quote or discuss, a single statutory provision.

C. The decision under review marks a reversion to rulings of the court below antedating *Parsons* v. *Smith* that permitted parties without any capital investment whatever in the coal in the ground, parties whose only investment was in their equipment or "in the enterprise," to obtain the benefit of the deduction for depletion none the less. Review in *Parsons* v. *Smith* was sought here on the footing of conflict with the foregoing line of decision. But after the affirmance in *Parsons*, the court below reduced to the single item of terminability the seven factors named in *Parsons* v. *Smith*, has been astute to distinguish that decision, has never given it ungrudging acceptance, and in the opinion now under review has simply paid it the lip service of citation.

D. Here, as in two other recent coal depletion cases that it decided, the court below has brushed aside findings made by the trier of facts. (1) The court below spoke of "oral leases," in the face of specific findings that negative alike any lease by Paragon to anyone and any lease by anyone to the contractors. (2) The court below blurred the Tax Court's specific findings showing that the contractors received a fixed price for the coal they mined and relied for their compensation solely on Paragon's personal covenant to pay such price. (3) The court below found a nonterminable right to mine to exhaustion in the face of specific findings to the contrary that explained why no specific tract could ever be assigned to any particular contractor.

E. The decision under review rested its result on a series of semanticized fictions, of which the most significant one was the assertion that, by reason of their expenditures and contracts, the contractors shared an economic interest in the mineral. This was the precise fiction that *Parsons* rejected; therein lies the basic fallacy of the decision under review; that is why that decision nullifies *Parsons* v. *Smith,* 359 U.S. 215.

ARGUMENT

We agree with the Commissioner that *Parsons* v. *Smith,* 359 U.S. 215, "presented the same issue on substantially similar facts" (Mem. Op. 2) as does this case, and that "the decision of the court of appeals is basically in conflict with *Parsons*" (Mem. Op. 3). But because we think that what the Commissioner accurately characterizes (*ibid.*) as "the clear error of the decision below" will become more apparent after a review of the governing guidelines, decisional and statutory, we believe that it will be helpful rather than burdensome to the Court if we devote more space to the fundamental principles concerned than would be necessary in an area less clouded over by semantic fog than the field of mineral depletion.

Briefly, it is our view that, under the decisions of this Court, only a party who actually owns a capital interest in the mineral in the ground is entitled to the deduction for depletion, because it is only the owner of the wasting capital asset whose investment in the mineral becomes depleted in the course of its extraction; that the dichotomy between an "economic interest" and an "economic advantage," first formulated by Chief Justice Hughes in *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362, and set forth in the Commissioner's regulations ever since, is in essence a formulation of the difference between ownership of the

mineral itself and ownership of a contractual right to extract that mineral; that accordingly it is not only unhelpful but actually confusing to concentrate on and thereafter to attribute controlling consequences to particular incidents of the contractual right to extract the mineral in individual cases; and that whatever may be the complications of attempting to draw the line between "economic interest" and "economic advantage" (or, on our formulation, between ownership and contractual right to extract) in situations involving the fractionalized interests characteristic in the oil and gas industry, there is no such complication in the case of coal, where the mineral is either owned in fee or else is divided only between lessor and lessee.

Moreover, in every case of coal mining involving taxable years subsequent to 1951, and here the years in question run from 1954 to 1957, the Internal Revenue Code specifically denied the lessor of coal lands any deduction for depletion (in return for permitting such lessor capital gains treatment of his royalties); necessarily allowed the lessee, who was specifically granted depletion in respect of his interest, the entire indivisible deduction for depletion; never once named parties contracting to mine coal belonging to others as statutory beneficiaries of the deduction for depletion; and by further unmistakable implication denied any depletion deduction to such parties. Moreover, in 1954 the Internal Revenue Code incorporated into its provisions the concept of ownership as the basis for calculating depletion.

In our view, "the clear error of the decision below" (Mem. Op. 3) involved several factors. First, the court below disregarded the consistent rule laid down here that limited the deduction for depletion to the owner of an interest representing a capital investment

in the mineral in the ground, in a situation where Paragon as lessee either owned the coal outright or else shared that ownership with its lessor. Second, the court below disregarded the provisions of the 1954 Internal Revenue Code that emphasized the importance of ownership and that specifically entitled Paragon to the entire depletion deduction because it was a lessee of coal lands, as well as those provisions of the Code that by outright omission and further necessary implication denied any such deduction to its contractors, respondents in No. 237, who simply had contracts to mine coal for Paragon. Third, the court below completely disregarded the applicable Internal Revenue regulation. Fourth, the court below baldly brushed aside findings of fact made by the Tax Court. Finally, the court below, through what can only be accurately characterized as a series of semantic fictions, found in the contracts to mine coal and the contractors' expenditures thereunder (all of which were deductible under other provisions of the Internal Revenue Code), a transfer or surrender from Paragon to its contractors of Paragon's capital investment in the minerals.

I. ONLY THE OWNER OF A CAPITAL INTEREST IN MINERAL IN THE GROUND IS ENTITLED TO A DEDUCTION FOR PERCENTAGE DEPLETION, AND CONSEQUENTLY A PARTY WHO SIMPLY HAS CONTRACTED TO MINE COAL BELONGING TO ANOTHER HAS NO RIGHT TO THAT DEDUCTION

In connection with the foregoing heading, we are of course aware that this Court has more generally used the expression "mineral in place"; we would normally do so also; but since discussions with some of the Commissioner's lawyers have suggested that the words "in place" do not convey an exact meaning to all concerned, we are substituting "mineral in the

ground" in our effort to clarify and to eliminate any possible suggestion of semanticism. *Accord, United States* v. *Cannelton Sewer Pipe Co.,* 364 U.S. 76, 88.

A. From United States v. Ludey, 274 U.S. 295, through United States v. Cannelton Sewer Pipe Co., 364 U.S. 76, this Court has emphasized that depletion is an allowance made to the owner for the exhaustion of capital assets.

We shall obviate the enumeration of a long series of cases that formulate the basic criterion for entitlement to the depletion deduction by merely quoting a key passage from *Parsons* v. *Smith,* 359 U.S. 215, 220:

> "The purpose of the deduction for depletion is plain and has been many times declared by this Court. 'It is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compenstion to the owner for the part used up in production.' *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362, 366. And see *United States* v. *Ludey,* 274 U.S. 295, 302; *Helvering* v. *Elbe Oil Land Development Co.,* 303 U.S. 372, 375; *Anderson* v. *Helvering,* 310 U.S. 404, 408; *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, 603. '[The depletion] exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired.' *Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308, 312. Save for its application only to gross income from mineral deposits and standing timber, the purpose of 'the deduction for depletion does not differ from the deduction for depreciation.' *United States* v. *Ludey,* 274 U.S., at 303. In short, the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset."

It will be noted that the word "owner" is used no less than three times in the foregoing quotation. We

emphasize that circumstance, because, as will be demonstrated below in the course of the argument, the importance of ownership has since been emphasized by the terms of I.R.C. 1954, § 614(a) (*infra*, p. 3a), while, contrariwise, failure to concentrate on ownership underlies most of the confusion and all of the error in the depletion decisions.

And, in the only full discussion of depletion since *Parsons* v. *Smith*, the Court once more emphasized ownership by concentrating on "capital assets." See *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81, 86, 88:

> "In summary, mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets. *Anderson* v. *Helvering*, 310 U.S. 404 (1940).
>
> * * * * *
>
> "Depletion, as we have said, is an allowance for the exhaustion of capital assets. It is not a subsidy to manufacturers or the high-cost mine operator."
>
> * * * * *
>
> "Depletion, as we read the legislative history, was designed not to recompense for costs of recovery but for exhaustion of mineral assets alone."

Perhaps this would be as good a place as any to point out that this brief discusses only entitlement to the percentage depletion allowance granted by §§ 611, 613, 614, and 631, I.R.C. 1954 (*infra*, pp. 1a-7a) and their statutory predecessors. We do not undertake to trace the statutory development of the depletion allowance that culminated in the present method of percentage depletion, a development fully set forth in *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 460-461, and in *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, 315-318.

B. The term "economic interest" when first used was accordingly limited to a property interest that represented a capital investment in the mineral in the ground.

In the first income tax act passed after the adoption of the Sixteenth Amendment, Congress lumped depreciation and depletion under a single heading,[3] no doubt because, as this Court later said in *United States v. Ludey*, 274 U.S. 295, 303, quoted with approval in *Parsons* v. *Smith*, 359 U.S. 215, 220, *supra*, p. 21, "In essence, the deduction for depletion does not differ from the deduction for depreciation."

Thereafter, beginning with the Revenue Act of 1918 and continuously since then, the depletion provisions of successive Internal Revenue Acts have provided, with scarcely any change in phraseology, that—quoting now from § 611(b)(1), I.R.C. 1954 (*infra*, p. 1a):

> "In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee."[4]

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[3] Sec. II B [Deductions] of the Act of October 3, 1913; c. 16, 38 Stat. 114, 167: "* * * sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year in which the computation is made * * *."

[4] Under § 23(m), I.R.C. 1939; § 23(m) of the Revenue Acts of 1938, 1936, and 1934; and § 23(l), Revenue Act of 1932, the language was, "In the case of leases, the deductions shall be equitably apportioned between the lessor and lessee."

In § 23(l) of the Revenue Act of 1928, the word was "deduction" in the singular.

In § 214(a)(9) of the Revenue Acts of 1926 and 1924 and in § 214(a)(10) of the Revenue Acts of 1921 and 1918, the provision read: "In the case of leases, the deductions allowed by this paragraph shall be equitably apportioned between the lessor and the lessee."

At the present time, see Point II below, pp. 61-65; there is no longer any apportionment in the case of coal leases, but that development need not be dealt with at this juncture.

In the case of oil wells, where division and indeed fractionalization of the mineral interests involved represents a frequent and perhaps even the usual practice, it soon became apparent that a rigid application of conventional common law estates might work injustice. Accordingly, in *Palmer* v. *Bender,* 287 U.S. 551, this Court held that, where the owner of an oil or gas lease transferred his lease to another in consideration of a bonus and royalties, the bonus so received was a return *pro tanto* of the transferor's capital investment in the oil, which entitled the transferor to a depletion allowance.

The Court, *per* Stone, J., said (287 U.S. at 558):

> "In the present case the two partnerships acquired, by the leases to them, complete legal control of the oil in place. Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute. *Lynch* v. *Alworth-Stephens Co.* [267 U.S. 364] * * *. When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor. *Burnet* v. *Harmel* [287 U.S. 103]; *Bankers Pocahantas Coal Co.* v. *Burnet* [287 U.S. 308] * * *. Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several

parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."

The foregoing passage is set forth in full, because it was the first to use the expression "economic interest." When those two words were later used without the limiting qualifications of the original formulation, the results unsettled and indeed distorted the entire depletion concept. Accordingly, we have quoted liberally from the source, in order to demonstrate that the entire emphasis there was on an economic interest representing a capital investment in the oil in place, i.e., in the ground. There is no warrant whatever in *Palmer* v. *Bender* for the notion of some of the later decisions, primarily those of the court whose decision is here being reviewed, that either an economic interest at large or even an economic interest in the enterprise is sufficient for entitlement to the deduction for depletion.

For, as the Court said in *Thomas* v. *Perkins,* 301 U.S. 655, 661,

> "If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.*"

We have added the italics by way of stressing the fundamental ownership guideline.

More recently in *Parsons* v. *Smith,* 359 U.S. 215, the Court reiterated the correctness of the capital-investment-in-the-oil-in-place limitation on the concept of "economic interest." It said (359 U.S. at 221-222, note 7):

> "The principles declared in the *Palmer* case have been recognized and applied by every subsequent decision of this Court that has treated with the subject.
>
> "*Helvering* v. *Bankline Oil Co.,* 303 U.S. 362, 367, literally adopted the language of the *Palmer* case upon the point.
>
> "In *Helvering* v. *O'Donnell,* 303 U.S. 370, 371, it was said: 'The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place. . . . *Palmer* v. *Bender,* 287 U.S. 551, 557; *Helvering* v. *Twin Bell Oil Syndicate,* 293 U.S. 312, 321; *Thomas* v. *Perkins,* 301 U.S. 655, 661; *Helvering* v. *Bankline Oil Co., supra.*'
>
> "*Helvering* v. *Elbe Oil Land Development Co.,* 303 U.S. 372, 375-376, declared that 'The words "gross income from the property," as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves.'
>
> "*Anderson* v. *Helvering,* 310 U.S. 404, 408-409, repeated the statement last quoted.
>
> "In *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, 603, the Court said: 'The test of the right to depletion is whether the taxpayer has a

capital investment in the oil in place which is necessarily reduced as the oil is extracted.'

"In *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 32, the Court said: 'It seems generally accepted that it is the owner of a capital investment or economic interest in the oil in place who is entitled to the depletion.' ".

C. The depletion allowance is consequently not available to one who has simply contracted with the owner of the mineral deposit for its extraction.

In *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362, decided five terms after *Palmer* v. *Bender,* this Court reviewed the cases, and, in a situation where the taxpayer had merely a contract with the owner of natural gas wells to extract the gasoline therefrom and to pay one third of the total proceeds of the sale of such gasoline to the owner, or, at the latter's option, to deliver one third of such gasoline to the owner, the taxpayer was not entitled to depletion because he had no capital investment in the natural gas in the ground.

Speaking through Chief Justice Hughes, the Court said (303 U.S. at 366-367, 368):

"In order to determine whether respondent is entitled to depletion with respect to the production in question, we must recur to the fundamental purpose of the statutory allowance. The deduction is permitted as an act of grace. It is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production. *United States* v. *Ludey,* 274 U.S. 295, 302. The granting of an arbitrary deduction, in the case of oil and gas wells, of a percentage of gross income was in the interest of convenience and in no way altered the fundamental theory of the allowance. *United States*

v. *Dakota-Montana Oil Co.,* 288 U.S. 459, 467. The percentage is 'of the gross income from the property',—a phrase which 'points only to the gross income from oil and gas'. *Helvering* v. *Twin Bell Syndicate,* 293 U.S. 312, 321. The allowance is to the recipients of this gross income by reason of their capital investment in the oil or gas in place. *Palmer* v. *Bender,* 287 U.S. 551, 557.

"It is true that the right to the depletion allowance does not depend upon any 'particular form of legal interest in the mineral content of the land'. We have said, with reference to oil wells, that it is enough if one 'has an economic interest in the oil, in place, which is depleted by production'; that 'the language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital'. *Palmer* v. *Bender, supra.* But the phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit. See *Thomas* v. *Perkins,* 301 U.S. 655, 661.

* * * * *

"Undoubtedly, respondent through its contracts obtained an economic advantage from the production of the gas, but that is not sufficient. The controlling fact is that respondent had no interest in the gas in place. Respondent had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance."

The *Bankline Oil* case was decided in March 1938. The differentiation therein made, between an economic

interest acquired by making a capital investment in the mineral in the ground, and a mere economic advantage that arose out of a contract to extract that mineral, was not reflected in the regulations promulgated on July 15, 1938, to implement the Revenue Act of 1938 (Treas. Regs. 101, Art. 23(m)-1), but it was copied almost verbatim from the *Bankline Oil* opinion into the first regulations under the Internal Revenue Code of 1939 (Treas. Reg. 103, § 19.23(m)-1, dated August 23, 1939). Since then, there have been no major changes in the economic-interest *versus* economic-advantage paragraph (Treas. Reg. 111, § 29.23(m)-1; Treas. Reg. 118, § 39.23(m)-1(a) and (b)), and, for the tax years in question in the present case, the applicable provision was § 1.611-1(b)(1) of the Regulations under I.R.C. 1954, as follows (italics added):

> "(b) **Economic interest.** (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired *by investment* any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess a mere economic or pecuniary advantage derived from production. For example, *an agreement between the owner of an economic interest* and another entitling the latter to purchase or process the product upon production or *entitling the latter to compensation for extraction or cutting does not*

convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders."

The foregoing language is entirely consistent with the thrust of Paragon's argument here, namely, that the depletion deduction inures to the owner of the mineral, not to the person who has merely contracted to extract that mineral. And, as we shall demonstrate below at the proper place, the foregoing language is entirely inconsistent with the result reached below in this case.

D. The transition from the criterion of an economic interest representing a capital investment in the mineral in the ground to that of an economic interest in the mining or drilling operation, which is indeed reflected in some intermediate decisions, results in granting a depletion allowance to one who had no mineral investment to deplete, and whose investment, being in non-mineral property, was recoverable through the allowance for depreciation or otherwise to the extent that it was used up in the process of extraction.

We turn now to the depletion cases decided after *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362, and before *Parsons* v. *Smith,* 359 U.S. 215. Those in this Court dealt with depletion rights in oil and gas cases, those in the courts of appeals primarily with coal mining situations, but virtually all of them blurred the distinction that had been drawn in the *Bankline* case and that from thence was carried into the regulations.

(1) The oil and gas cases here through the 1945 Term.

Two other cases were decided by this Court on the same day as *Bankline Oil,* followed it, and were consistent with its teaching. *Helvering* v. *O'Donnell,* 303 U.S. 370; *Helvering* v. *Elbe Oil Land Co.,* 303 U.S. 372.

A few years later, however, the discussion in *Anderson* v. *Helvering,* 310 U.S. 404, did little to clarify matters, and at the 1945 Term there was laid down a foundation of confusion on the strength of which the lower courts, notably the court below, completely altered the concept of "economic interest," so that, for an economic interest that represented a capital investment in the mineral in the ground, there was substituted the wholly different criterion of an economic interest representing an investment in the mining enterprise, generally in machinery and equipment, an investment that was of course independently recoverable through the allowance for depreciation.

Thus, in *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, the Court found it necessary to "explain" no less than three earlier decisions (*Anderson* v. *Helvering, Helvering* v. *O'Donnell,* and *Helvering* v. *Elbe Oil Land Co.,* all *supra*), while in the second depletion case of the 1945 Term, *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, the prevailing opinion was occupied with extensive "explanations" of one of those same earlier decisions that that Court had just finished "explaining" in *Kirby Petroleum* only a few months earlier (*Helvering* v. *Elbe Oil Land Co., supra*).

This circumstance prompted one member of the Court in *Burton-Sutton,* to say (328 U.S. at 38),

> "Nothing better illustrates the gossamer lines that have been drawn by this Court in tax cases than the distinction made in the Court's opinion between *Helvering* v. *Elbe Oil Land Co.,* 303 U.S. 372, and this case. To draw such distinctions, which hardly can be held in the mind longer than it takes to state them, does not achieve the attainable certainty that is such a desideratum in tax matters, nor does it make generally for respect of law."

We shall not in the present coal case venture a reconciliation of the foregoing oil and gas cases, if indeed they can all be reconciled. It is sufficient to note here that, because of the illness of counsel, *Burton-Sutton* went unargued for the Government (J. Sup. Ct., Oct. T. 1945, pp. 195, 196, 199). No doubt the case was not intended to mark a new departure. But if, as many judges have insisted, "cases that are not argued are not well decided," compare this Court's Rule 45(1), then *Burton-Sutton* is living proof of the proposition. It was read elsewhere to reflect doctrinal fission here, and certainly it set off a chain reaction in the lower courts, particularly in the court below, which, in a series of decisions that we discuss later on (Point III C, *infra*, pp. 85-90), relied on *Burton-Sutton* to allow depletion to mere contractors in coal mining cases, parties with not a penny invested in the coal in the ground, parties whose entire investment was in machinery. The latter decisions changed completely the basic concept and rationale of the mineral depletion allowance, and the opinion now under review shows that, notwithstanding *Parsons* v. *Smith,* their ghost has not yet been laid.

We pass the later oil and gas cases here for the further reason, also to be developed in more detail below, that the fractionalization of interests and the complex transactions so characteristic in the usual oil and gas situation, never appear in the coal cases. Briefly, in coal mining there are never more than three interests, and frequently only two: There is the owner of the fee in the coal deposits, who may or may not own the surface of the soil in addition. In either situation, the owner of the coal may convey or lease the mineral interest therein to another and either the owner of the

entire fee, or the owner of the coal, or the lessee of the mineral may arrange for independent contractors to mine the coal.

(2) The Southwest Exploration case.

(i) *Its facts and holding.* Just a few years before the decision in *Parsons* v. *Smith*, 359 U.S. 215, the Court decided *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308.

Two cases were actually involved there, that of the Southwest Exploration Company, which was doing the actual drilling of offshore oil deposits under a lease from the State of California, and that of the Huntington Beach Company and its associates, the owners of the indispensable upland property from which the drilling was done, and without the use of which drilling was impossible. "Southwest agreed to pay to such owners 24½% of the net profits for the use of their land." 350 U.S. at 309. The Ninth Circuit, affirming the Tax Court, had granted Southwest Exploration full depletion, for the reason that Huntington had no capital interest in and no capital investment in the oil and gas in the ground. *Commissioner* v. *Southwest Exploration Co.*, 220 F. 2d 58 (C.A. 9), affirming 18 T.C. 961. The Court of Claims, disagreeing, had allowed Huntington's claim for depletion, on the ground that it had "an economic interest in the production of the oil." *Huntington Beach Co.* v. *United States*, 132 C. Cls. 427, 433, 132 F. Supp. 718, 721. This Court, reviewing both cases, held Huntington entitled to depletion, saying (350 U.S. at 317):

> "We decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an indispensable

contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received."

If *Southwest Exploration* were thus limited to its precise facts, it would not help the respondents in No. 237, who very plainly cannot bring themselves within its narrow ambit. This Court can accordingly defer reconsideration of that decision until the same factual situation again arises. If we were similarly to avoid further discussion of the decision, our path would be easier—and assuredly our present brief would be substantially shortened.

But the temptation thus to take the easy road of expediency cannot be indulged. Not only is *Southwest Exploration* still being invoked by our adversaries to defend the palpably erroneous result reached below in the present case (Br. Op., No. 237, p. 7), but, primarily, that decision runs counter to our formulation, and counter to this Court's repeated formulation, of a consistent, logical, and easily applicable rationale of the depletion deduction.

Even as limited, the reasoning of *Southwest Exploration* is inconsistent with both the earlier and the later depletion cases here, because it reached its result on an essentially fictitious basis—strictures that can easily be documented. At any rate, we are convinced that candor and advocacy join in requiring us to grasp the nettle firmly, and, in full and frank discussion, to undertake to draw its sting.

(ii) *Was* Southwest Exploration *consistent with earlier cases?* The statutory allowance for depletion,

said Mr. Chief Justice Hughes in the *Bankline Oil* case, "is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation *to the owner* for the part used up in production." 303 U.S. at 366. We have added the italics, in order to ask the question, Just what mineral deposits did Huntington of the indispensable uplands own that were used up in production? True, Huntington made a contribution to the mining venture without which mining would not have been possible, but Huntington's property was not depleted, since it owned just as much oil at the start of the operation as at the end—which is to say, not a single drop. The incontrovertible fact is that nothing owned by Huntington was depleted in the slightest or would ever be depleted, and that its agreement whereby its contribution of non-depletable and undepleted real estate was compensated simply gave it a percentage of the net profits to be realized from the drilling operation. Under *Bankline* and the Treasury Regulations couched in *Bankline* language, that agreement gave it only an economic advantage, a profitable contractual right arising out of the drilling.

(iii) *The rationale of* Southwest Exploration. A short paragraph from the Court's opinion exposes the reasons underlying its results (350 U.S. at 316):

> "Proximity to the offshore oil deposits and effect of the state law combined to make the upland owners essential parties to any drilling operations. This controlling position greatly enhanced the value of their land when extraction of oil from the State's offshore fields became a possibility. The owners might have realized this value by selling their interest for a stated sum and no problem of depletion would have been presented. But in-

stead they chose to contribute the use of their land in return for rental based on a share of net profits. This contribution was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. No more is required by any of the earlier cases."

The key sentence in the foregoing passage—"This contribution was an investment in the oil in place sufficient to establish their economic interest"—is, we respectfully submit, sheerest fiction. One can only invest in oil in place—oil in the ground—by becoming an owner or part owner of that oil. All Huntington owned was land containing no oil whatever. It is ownership that represents the essential capital investment, just as it is ownership of the wasting mineral asset that underlies entitlement to the depletion allowance. And surely to have added, see the quotation, that "No more is required by any of the earlier cases," involved either a thoroughgoing misreading or an obvious overlooking both of *Bankline* and of *Thomas* v. *Perkins,* 301 U.S. 655, 661 (quoted above at p. 25).

(iv) *Has the rationale of* Southwest Exploration *been followed since?* It is true that *Southwest Exploration* was duly cited in *Parsons* v. *Smith,* 359 U.S. 215, no less than four times (p. 219, note 5; p. 220, twice; p. 222, note 7). Much language from *Southwest Exploration* was indeed quoted in *Parsons* that is entirely consistent with the holdings of *Parsons* and of many of the earlier cases. But the approach and much of the reasoning of *Southwest Exploration* are at the very least difficult to reconcile with *Parsons*—as we shall now show.

(a) In *Huss* v. *Smith*, 255 F. 2d 599 (C.A. 3), the other case dealt with in the *Parsons* opinion here, Judge Kalodner dissented below, citing *Southwest Exploration* for the proposition that "No money need be invested in the mineral deposit" (255 F. 2d at 603). Both sets of petitioners in the *Parsons* case relied heavily on *Southwest Exploration* for the same proposition (Pet. Br., No. 218, Oct. T. 1958, pp. 10-13; Pet. Br., No. 305, Oct. T. 1958, pp. 14-16).

(b) Inasmuch as the upland owners in *Southwest Exploration* had no capital investment whatever in any of the oil being extracted (their capital investment being in their own nonproducing upland); inasmuch as their own capital asset property was in no sense being depleted because at the end of the operation they would still own just as much oil as at the beginning, which is to say, not even a cupful; and inasmuch as the drilling company did not agree to surrender and did not actually surrender to Huntington any of their capital interest in the oil in place that they had leased from the state, it seems plain that the holding in *Southwest Exploration* cannot be squared with the re-emphasis on the necessity for capital investment that permeates the *Parsons* opinion. Once attention is concentrated on the basic principle restated in *Parsons* that "the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset" (359 U.S. at 220), it follows that there is no longer any support for *Southwest Exploration*, since, obviously, the upland owner did not own any interest in the oil that was being pumped out of the wells. Consequently, however much the two cases may be distinguished on their facts, their divergent reasoning cannot fairly stand together.

(c) It may be helpful also, by way of further demonstrating the essential inconsistency between *Southwest Exploration* and *Parsons,* to retrace the steps whereby the Court reached the conclusion in the earlier case that the non-owner of the oil nonetheless had a capital investment in the oil, and in the later one that the non-owner of the coal had no capital investment in the coal. Here are the successive passages:

Southwest Exploration (350 U.S. at 316):

"Recognizing that the law of depletion requires an economic rather than a legal interest in the oil in place, we may proceed to the question of whether the upland owners had such an economic interest here. We find that they did. Proximity to the offshore oil deposits and effect of the state law combined to make the upland owners essential parties to any drilling operations. This controlling position greatly enhanced the value of their land when extraction of oil from the State's offshore fields became a possibility. The owners might have realized this value by selling their interest for a stated sum and no problem of depletion would have been presented. But instead they chose to contribute the use of their land in return for rental based on a share of net profits. This contribution was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced."

Parsons (359 U.S. at 224-225):

"It stands admitted that before and apart from their contracts, petitioners had no investment or interest in the coal in place. Their asserted right to the deduction rests entirely upon their contracts. Is there anything in those contracts to

indicate that petitioners made a capital investment in, or acquired an economic interest in, the coal in place, as distinguished from the acquisition of a mere economic advantage to be derived from their mining operations? We think it is quite plain that there is not.

"By their contracts, which were completely terminable without cause on short notice, petitioners simply agreed to provide the equipment and do the work required to strip mine coal from designated lands of the landowners and to deliver the coal to the latter at stated points, and in full consideration for performance of that undertaking the landowners were to pay to petitioners a fixed sum per ton. Surely those agreements do not show or suggest that petitioners actually made any capital investment in the coal in place, or that the landowners were to or actually did in any way surrender to petitioners any part of their capital interest in the coal in place. Petitioners do not factually assert otherwise. Their claim to the contrary is based wholly upon an asserted legal fiction. As stated, they claim that their contractual right to mine coal from the designated lands and the use of their equipment, organizations and skills in doing so, should be regarded as the making of a capital investment in, and the acquisition of an economic interest in, the coal in place. But that fiction cannot be indulged here, for it is negated by the facts."

The difference in these two approaches lies in the concentration of the second one on its inquiry whether there was any transfer of the ownership of the mineral. Prior to the making of the respective contracts, Huntington in the first case, like Parsons and Huss in the second, had no interest in the mineral, either by way of "economic interest" or of any other kind of interest. But in the first case the Court said that when

Huntington *et al.* contributed the use of their land, "their contribution was an investment in the oil in place sufficient to establish their economic interest," while in the second the Court pointed out that the stripping contracts of Parsons and Huss "do not show or suggest that petitioners actually made any capital investment in the coal in place, or that the landowners were to or actually did surrender to petitioners any part of their capital interest in the coal in place."

The sentence just quoted from *Southwest Exploration,* when set against the first clause of the sentence from *Parsons,* probably does not advance the argument beyond "I am" "You're not" "I am too." But the second clause in the *Parsons* sentence is really the nub of the matter and underscores the fallacy of *Southwest Exploration*: Where and how did the Southwest Exploration Company, the drilling concern that held the oil lease, ever surrender or transfer any part of its estate in the oil to Huntington? Of course it never did, in any manner or by any means; indeed, it is the absence of any such surrender or transfer that underlies the fiction inherent in the *Southwest Exploration* decision, a fiction that the Court in *Parsons* advisedly refused to follow.

(d) The Court's latest reasoned pronouncement in the depletion area, *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, is similarly at variance with the reasoning of *Southwest Exploration.* In *Cannelton,* the Court repeatedly pointed out the purpose of mineral depletion—"an allowance from income for the exhaustion of capital assets" (pp. 81, 86), "designed not to recompense for costs of recovery but for exhaustion of mineral assets alone" (p. 88). Surely the *Cannelton* approach cannot rationally be reconciled

with the decision in *Southwest Exploration*, which allowed depletion to the upland owners, whose only capital asset, the upland property, was never exhausted in any respect, and which could not possibly be exhausted by the extraction of oil from another's land, no matter how long continued.

(v) *How explain the result in* Southwest Exploration? As has been indicated above at page 33, both the upland owner as well the lessee of the oil were before the Court in *Southwest Exploration*. The government, which had necessarily taken inconsistent litigating positions below in order to protect the revenue, was only a stakeholder in this Court. But it threw its weight into the scales against the drilling company, and here urged that depletion be allowed the upland owner. It summarized its arguments in this Court as follows (Pet. Br., No. 286, Oct. T. 1955, pp. 11-12 [our italics]):

> "The reasons relied on by the courts below for their conclusion that the upland owners lacked a depletable interest are not persuasive. Thus, the facts that the upland owners did not have legal title to the deposits, did not have the right to produce oil and gas and *did not make a cash investment in the mineral deposits*, do not furnish a solid basis for the conclusion that the upland owners did not have a depletable interest. Indeed, the decisions of this Court uniformly demonstrate that these are not sufficient reasons for denying the upland owners the depletion deduction.
>
> * * * * *
>
> "If the Court disagrees with our contention * * * that the upland owners' right to share in the taxpayer's net profits was a depletable interest because the upland owners made a contribution of the use of their property which was essential to the pro-

duction of oil and gas, we urge, alternatively, that it be held that the upland owners acquired a depletable interest merely from the fact that they became entitled to share in the operator's net profit. It would be a logical extension of the principles applied in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, and *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, to hold that *any person who acquires the right to share in the net profits derived from the production of oil and gas has a depletable interest,* and that it is immaterial how that interest was acquired * * *. While the broad rule for which we here contend cannot be reconciled with the decisions in *Helvering* v. *O'Donnell*, 303 U.S. 370, and *Helvering* v. *Elbe Oil Land Company*, 303 U.S. 372, it is believed that those decisions are out of harmony with the *Kirby* and *Burton-Sutton* cases and should be regarded as no longer authoritative."

The foregoing excerpt shows two departures from approved doctrine. First, the Government's willingness "to hold that any person who acquires the right to share in the net profits derived from the production of oil and gas has a depletable interest" reflects a complete abandonment of the guidelines governing depletion that had originally been laid down by judges of the stature of Mr. Justice Brandeis, Mr. Justice Stone, and Mr. Chief Justice Hughes, in, respectively, *United States* v. *Ludey,* 274 U.S. 295, *Palmer* v. *Bender,* 287 U.S. 551, and *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362. Second, the Government's brushing aside as immaterial of the circumstance that the upland owners "did not make a cash investment in the mineral deposits" involves a rejection of similar guidelines that were later reaffirmed in *Parsons* v. *Smith,* 359 U.S. 215, and again in *United States* v. *Cannelton Sewer Pipe Co.,* 364 U.S. 76, viz., the rule that depletion is an allowance

to permit a recoupment of the owner's capital investment in wasting assets, that it is an allowance for the exhaustion of capital assets. Both of these departures may well have contributed significantly to the strange result reached in *Southwest Exploration*.

(vi) *How should* Southwest Exploration *now be treated?* If the *Southwest Exploration* case were actually read as being strictly limited to its particular and unique facts, it might, as we have said, be left undisturbed until its precise situation once more arose. Similarly, if it concerned simply another manifestation of an ingenious splitting up of property interests in oil and gas, its resolution could also be left to another day. But, just as most decisions have a sweep beyond their original confines, so *Southwest Exploration* has invaded the coal field. Thus, in a recent case decided by the Sixth Circuit, *Omer* v. *United States*, 329 F. 2d 393, where it was held that the owner of the surface overlying the coal lands belonging to others was not entitled in respect of his royalties to capital gains treatment under I.R.C. 1954, § 631(c) (*infra*, p. 4a), the Government none the less still stipulated a depletion allowance to the owner of the surface (329 F. 2d at 395, note 2):

> "The brief of appellee contains the following explanation of this allowance: 'Because of the apparent hardship to the taxpayers in view of the probable destruction of their land by the strip-minging operation and because Southwest Expl. Co. may possibly justify a conclusion that the taxpayers *acquired* an economic interest in the coal in place in the transaction with Badgett, the Commissioner conceded in the District Court that the taxpayers are entitled to a depletion allowance. That concession has been taken into account in the judgment.' "

The discussion above—the rather lengthy discussion above, we fear—will have made it entirely clear that the result in *Southwest Exploration* cannot fairly be reconciled with the shaping decisions in *Ludey, Palmer,* and *Bankline* on the purpose and scope of the depletion allowance. It seems to us similarly clear that the discussion in *Southwest Exploration*, which manfully attempted to rationalize and to reconcile the later decisions, from the 310th through the 328th U.S., so far concentrated on the distinctions and explanations made therein that, unavoidably, the contours of the basic depletion concept became not only blurred but actually distorted because that concept had become enshrouded in a veritable fog of words. Finally, we think it clear that the restatement in *Parsons* of the basis of the depletion allowance, in the terms originally used by this Court, with the emphasis on transfer of ownership, on capital investment in mineral in the ground, and on the depleting mineral asset, as well as the repeated reassertion in *Cannelton* that depletion "is an allowance for the exhaustion of capital assets," combine to demonstrate that *Southwest Exploration*, which indeed allowed depletion to one who never owned any mineral and whose property was never exhausted by mining, constituted "a departure from theretofore established principles" (*Sonneborn Bros.* v. *Cureton*, 262 U.S. 506, 520).

The formulation of the reasons justifying the allowance for depletion, made by Chief Justice Hughes in *Bankline*, and repeated in *Parsons*, "is as strong today as when it was written, and it would be a source of confusion and injustice if, through too broad expressions in a few opinions, a different conclusion from that to which it should carry us were to obtain"

(*Sonneborn Bros.* v. *Cureton*, 262 U.S. at 521). In short, we believe that *Southwest Exploration* "can no longer be guiding" (*Rochester Tel. Corp.* v. *United States*, 307 U.S. 125, 143), and that accordingly it may now appropriately "be allowed a deserved repose" (*Adkins* v. *Children's Hospital*, 261 U.S. 525, 567, 570).

E. An economic interest representing a capital investment in coal in the ground can be acquired only by appropriate conveyance or contract to convey.

When we turn to the problem of the present case, which involves the entitlement to the depletion deduction for coal, we are no longer concerned with the fractionalization of interests and the complexity of arrangements that is so characteristic of oil and gas wells. The possibilities of dividing up interests in coal lands are so much more limited that by comparison they suggest virtually a stark simplicity. We believe that the listing that follows is for all practical purposes complete (except of course for joint heirship and partnership ownership of the particular interests to be enumerated).

One, ownership of the land in fee, which includes ownership of the surface as well as ownership of the underlying coal.

Two, ownership only of the coal underlying the land, which is thus severed from ownership of the surface.

Three, lease of the entire fee including the coal.

Four, lease of the underlying coal only,[5] with or without an obligation to mine a stated percentage of

[5] On occasion, as in some of the leases involved in the present case, only particular seams of coal are leased. R. 197, 200, 201, 202-203.

the coal. Such an obligation, under the law of many states, is treated as a sale of the coal in the ground.

We are not aware of any further situations.

All of the foregoing interests, very plainly, are ownership interests, in greater or less degree; they are estates in land; and if the expression "capital investment in the coal in place" has any meaning whatever, then each of the enumerated interests represents such a capital investment.

How, then, does one acquire a capital investment in the coal in place? It seems to us obvious that the only possible answer is, By acquisition of one or more of the interests enumerated above, and that such an acquisition is evidenced either by a conveyance or else by a contract to convey (which under familiar principles vests the beneficial interest in the purchaser once the contract is executed). Under that analysis, a will of course qualifies as a conveyance—as does the passage of property by intestacy, although that final variant may for most purposes be disregarded.

Accordingly, neither the buying of machinery for mining coal, nor the execution of a contract to mine coal, nor the making of expenditures preparatory to the mining of coal, can operate to transfer to the mining contractor from the owner or part owner of the coal in the ground any property interest in that coal.

Mineral rights, in whatever degree, are universally recognized as property rights, which carry the burdens of ownership, e.g. in respect of property taxes, along with the benefits that flow from ownership.

It follows that to speak of a capital investment in coal in the ground is to use an expression synonymous

and coextensive with ownership of the coal in the ground, including in "ownership" for this purpose any ownership interest whatever.

We submit that, unless words are to be used to obfuscate rather than to clarify meaning, "capital investment in the mineral in place" cannot have any meaning other than ownership of the coal in the ground. Indeed, the words "capital investment" plainly negative the notion that in seeking to ascertain entitlement to the depletion deduction, it is either appropriate or helpful to look to income, however proper that technique assuredly is in tax cases not involving depletion. E.g., *Burnet* v. *Harmel*, 287 U.S. 103; *Griffiths* v. *Helvering*, 308 U.S. 355; *Helvering* v. *Horst*, 311 U.S. 112; *Commissioner* v. *Brown*, No. 63, this Term. The reiterated criterion in the depletion cases is ownership of the wasting mineral asset, see discussion in Point IA, pp. 21-22, *supra*, and indeed once attention is diverted from ownership and concentrated on income the inevitable result would be the conclusion, alternatively urged on the Court by the Government in *Southwest Exploration* (quoted *supra*, pp. 41-42), that "any person who acquires the right to share in the net profits derived from the production of [a wasting mineral] has a depletable interest." That conclusion was not adopted by the Court even in *Southwest Exploration*, and it was decisively rejected in *Parsons*, which reaffirmed the importance of ownership.

We submit further that the capital investment in the coal in the ground, the ownership of the coal in the ground, can only be transferred by the means appropriate for the transfer of such a property interest.

There must be a transfer by, there must be a surrender of property interest by, the former owner—and such a transfer and/or surrender cannot be found or spelled out of other dealings by a species of magician's presto-chango.

The party who simply contracts to mine coal owned by another, regardless of expenditures made, regardless of the terms of such contract insofar as they do not purport to convey the property interest in the unmined coal, regardless of the extent of the investment made in machinery and equipment, simply does not by any combination of, or indeed all of, the foregoing acts, obtain thereby any property right, any ownership right, any capital investment, or any economic interest representing a capital investment, in the coal in the ground.

To assert the contrary involves purest fiction, and involves either recourse to the most slippery kind of sheer semanticism, or else the prestidigitation of now-you-see-it-now-you-don't, or—as in the opinion now under review—both elements.

F. In view of the controlling principle that only the owner of a capital investment in the coal in the ground is entitled to the deduction for depletion, since it is his assets alone that become exhausted in the mining process, the terms of the contracts he makes for mining the coal are meaningful only for the light they throw on the issue of ownership, and have no independent significance.

In concluding that the petitioners in *Parsons* v. *Smith* "did not actually make any capital investment in, or acquire any economic interest in, the coal in place, and that they may not fictionally be regarded as having done so" (359 U.S. at 225), the Court pointed to seven factors. All were important, and all demon-

strated the absence of any capital investment by Parsons and Huss in the coal in the ground. But those facts bore only on the ownership issue—to whom did the unmined coal belong?—and it is, we submit, quite fallacious to attach independent or indeed controlling significance to particular elements.

We shall proceed to consider the enumerated factors of the Parsons and Huss contracts, as well as some others that have been emphasized in the decisions.

Fixed price for the coal. Item (6) in *Parsons* v. *Smith*, 359 U.S. at 225, "that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in *Huss*, agreed to be in 'full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work.' "

Any arrangement for mining under which the contractor receives a fixed price for the coal he extracts from the ground is consistent only with the fact that the landowner or lessee owned the coal, that the landowner or lessee bore the burdens and the benefits of ownership as the case might be, and that the contractor was being paid for the labor of mining coal that belonged to another. It would indeed be a strange kind of ownership if the contractor could be insulated from fluctuations in the sale price of a product that on his assertion he owned prior to extraction. Accordingly, a good many of the early Tax Court rulings considered that a fixed price paid per ton constituted a virtually conclusive criterion for denying the contractor any deduction for depletion. E.g., *Morrisdale Coal Mining Co.,* 19 T.C. 208; *Matagorda Shell Co.,* 29 T.C. 1060; *Nathan Fink*, 29 T.C. 1119.

But, while a fixed-price arrangement in most instances barred almost automatically the contractor's claim to a share in the allowance for percentage depletion, the contrary result does not follow. Consequently, other early Tax Court rulings holding that the contractor is entitled to depletion simply because his compensation for extracting the coal is measured by a percentage of the price at which it is ultimately sold are, in our view, erroneous. E.g., *James Ruston*, 19 T.C. 284; *Helen G. Brown*, 22 T.C. 58; *Virginia B. Coal Co.*, 25 T.C. 899; *Walter Bernard McCall*, 27 T.C. 133; *Denise Coal Co.*, 29 T.C. 528. Significantly enough, the depletion part of *Denise* was reversed in *Denise Coal Company* v. *Commissioner*, 271 F. 2d 930 (C.A. 3), decided after *Parsons*, while the first *McCall* case was not followed once *Parsons* had been decided here. See *Walter Bernard McCall*, 37 T.C. 674, affirmed, 312 F. 2d 699 (C.A. 4). And, in *Utah Alloy Ores, Inc.*, 33 T.C. 917, 921, 922, where the miners received a percentage of the price paid the landowner rather than a fixed price, the Tax Court in that post-*Parsons* decision denied them depletion where the other facts clearly showed that the miners had made no capital investment in the mineral in place.

Where the contract is thus drawn, to compensate the contractor with a percentage of the ultimate sales price, it is true that the latter assumes the risk of the market. Many contractors do, in greater or less degree. But such a profit-sharing arrangement—or loss-sharing, as the case may be—does not supply the primary requirement reemphasized in *Parsons* v. *Smith* that the coal deposits being depleted must represent the taxpayer's capital investment as a prerequisite to his obtaining any deduction for depletion. The circum-

stance that the owner of the coal can find another party to share both his risks of loss as well as his hopes of gain does not amount to a transfer of his ownership in the unmined coal sufficient to justify a depletion allowance for the contractor who has neither made nor acquired a capital investment in the coal in the ground. (We show below, pp. 77-79, that the Tax Court's findings negative any such sharing in the present case.)

Terminability. Item (3) in *Parsons* v. *Smith*, 359 U.S. at 225, "that the contracts were completely terminable without cause on short notice."

Not only this Court but also the Third Circuit and the district court in the *Parsons* and *Huss* cases placed substantial reliance on the terminability clause in denying to these contractors any deduction for depletion. *Parsons* v. *Smith*, 255 F. 2d 595, 597-598 (C.A.3); *Huss* v. *Smith*, 255 F. 2d 599, 600-601 (C.A. 3); *Huss* v. *Smith*, 150 F. Supp. 224, 231-233, 234 (E.D. Pa.)

In a series of coal depletion cases decided by the court below, both before and after this Court's rulings in *Parsons*, so much importance was attached to the terminability of the mining contracts concerned that, in one instance, the court below brushed aside the district court's finding of fact that the oral contract was terminable, and then simply asserted the contrary without further reference to the evidence. See pp. 89 and 94-95, below.

In the present case, as we shall duly elaborate (pp. 71-76, below), the contractor had, prior to *Parsons* v. *Smith*, made oath before the Internal Revenue Service (R. 236, 244) that "The contract specified the right of termination by either party at any time, but the

question never arose between the partnership and Paragon." By the time of the trial of this case, however, the court below had read *Parsons* as resting primarily on the terminability of the agreements there involved. The contractors here then testified that their agreements with Paragon were nonterminable. Pp. 73-76, *infra*.

Our view that the right to terminate is not significant coincides with that of the Tax Court in two post-*Parson* cases.

In *Utah Alloy Ores, Inc.*, 33 T.C. 917, 921, the contractors had leases for one year terms; those leases were cancellable only for cause during the year; and they were usually renewed. The Tax Court denied the contractors depletion, saying (33 T.C. at 922),

> "The petitioner's [i.e., the landowner's] investment alone suffered depletion from the extraction of the ore. There is nothing in this arrangement to indicate that the miners made any capital investment in the mineral in place, which investment suffered depletion."

Similarly, in the present case the Tax Court (R. 221) said:

> "While such right on the part of the landowner to terminate an agreement on short notice and without cause may [illegible] far toward limiting the contractor's right to the depletion deduction, we do not think the absence of a specific right to terminate necessarily gives the contractor an economic interest in the coal in place."

For, after all, even a non-terminable contract to cut another's grass in perpetuity does not vest in the opera-

tor of the lawnmower any proprietary interest in the front yard he agrees to trim.

Mining to exhaustion. Parsons had no right to mine to exhaustion, while Huss in effect did, at least in the sense that it was only to continue until further work was deemed unprofitable. The Third Circuit relied heavily on the first circumstance in its *Parsons* opinion, 255 F. 2d at 597, but in *Huss* rested its denial of percentage depletion to the contractor on the termination clause, 255 F. 2d at 600-601. The court below in *Elm Development Co.* v. *Commissioner*, 315 F. 2d 488 (C.A. 4), attached controlling significance to the fact that the contractor there had the right to mine to exhaustion. Finally, in this case, in the teeth of a specific finding of fact by the Tax Court on sharply conflicting oral testimony that (R. 215) "The contractors were not obligated to mine any specific amount of coal and were not specifically given the right to mine any particular area to exhaustion," the court below none the less found that a right to mine to exhaustion existed (R. 255).

This Court in *Parsons* said nothing concerning the right to mine to exhaustion, an omission that confirms us in our view that this factor is quite irrelevant in considering whether the contractor is entitled to a deduction for depletion.

The terms of the contract to mine the coal, whether the arrangement is one for mining all of the underlying coal, or for an approximated portion thereof, or to extract all of the coal that can be mined in a given period of time, throw no light whatever on who has the capital investment in that coal. Before any contract to mine is made, none of the coal in the ground,

obviously, belongs to the prospective mining contractor; it belongs to the owner of the coal, whether lessee or lessor or holder of the fee. How then, does that owner divest himself of his property right in that coal? If the court below is right, he does so simply by making a more comprehensive contract for extracting his own coal. That conclusion, to speak very mildly indeed, is a palpable *non sequitur.* Indeed, the premise of the opinion below, that there is effected a transfer of capital investment once the owner of the coal agrees with a contractor to mine all the coal in the particular tract, plainly involves a departure from reality and from rational legal relationships to the realm of fiction and of magic, and involves as well a passage Through the Looking Glass to the unconquerable and invincible semanticism of Humpty Dumpty: "When *I* use a word, it means just what I choose it to mean—neither more nor less."[6]

Surrender or transfer of capital investment. Item (4) in *Parsons* v. *Smith*, 359 U.S. at 225, "that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place."

This was the element missing in *Southwest Exploration,* see discussion *supra,* at pp. 38-40, and this is the element that is likewise missing in every reported case in which contractors who had no property right or capital investment in the coal in the ground before their mining operations started nonetheless claim an allowance for depletion deduction thereafter.

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[6] See the extensive discussion of "the profundity in Humpty Dumpty's whimsical discourse on semantics" in M. Gardner, ed., *The Annotated Alice* (New York, 1960) 268-270, note 6.

Indeed, if attention be carefully focused on the element of surrender (or transfer, because surrender of an interest involves its transfer to another), if every coal mining contractor claiming an allowance for depletion were sharply questioned on a single point, namely, "How and when was the lessee's capital investment in the coal in the ground ever transferred to you?," then, we submit, the contentions rejected by *Parsons* v. *Smith* but which have now been readopted by the court below, would have been finally laid to rest long since. Indeed, to press the question just framed serves to expose the utterly fictitious nature of the holding below (R. 255) that "by virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral." Significantly enough, the opinion below failed to add, no doubt because it could not, the original qualification from *Palmer* v. *Bender*, see pp. 24-25, above, that the economic interest must represent a capital investment in the unextracted mineral. Had that qualification been included, then the fiction underlying the quoted sentence would have become apparent, for then it would have read, "by virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral in place which represented their capital investment."

If that were indeed the law, then the Bumbles of the coal industry might be expected to make the usual comment. But it is not the law, for the unassailable reason that it does not state the fact.

Other indicia negativing ownership by the contractors of the coal in the ground. Items (5) and (7) in *Parsons* v. *Smith*, 359 U.S. at 225, "that the coal

at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners"; and "that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts."

Both factors just cited completely negative any ownership or capital investment in the coal in the ground on the part of the contractors, because both imposed conditions on the disposition of the coal entirely inconsistent with any vestige of ownership interest therein by the contractors. For if the contractors had actually owned the coal in the ground, they would have been free to dispose of it anywhere, and hence could to that extent have looked elsewhere for their compensation.

How the coal contractors' actual and non-fictitious investments were recoverable. Items (1) and (2) in *Parsons* v. *Smith*, 359 U.S. at 225, "that petitioners' investments were in their equipment, all of which was movable"; and "that their investments in equipment were recoverable through depreciation."

There is much talk, in the opinion below as well as in other decisions antedating *Parsons* v. *Smith,* about the expenditures made by coal mining contractors, on occasion, as in the stripping cases, very heavy expenditures for acquisition of the elaborate and complex machinery that stripping requires. But whatever the nature or extent of the expenditures made by such contractors, they were all deductible under appropriate provisions of the Internal Revenue Code.

To the extent that a contractor's capital investment in either complex or simple machinery was or is being

used up in the course of his mining operations, he had the right to deduct depreciation, on any one of several formulas, and thus to recover his entire investment in such machinery. I.R.C. 1954, § 167. His other expenditures were similarly compensable. To the extent that these other outlays could properly be treated as non-capital, they were plainly deductible as ordinary and necessary business expenses. I.R.C. 1954, § 162(a). And to the extent that his other expenditures were to be regarded as capital, they were subject not only to the deduction for depreciation, but also to capital or ordinary loss treatment with applicable carrybacks and carry-forwards if those assets were thereafter disposed of at less than their book value. I.R.C. 1954, §§ 172, 1001, 1002, 1211, 1212, 1231.

But, since the contractor did not invest any capital in the coal in the ground, the wasting mineral asset, so as to acquire any ownership interest in that coal, he did not make the particular investment that is the prerequisite to the deduction for percentage depletion. Indeed, to grant him percentage depletion in addition to the other deductions just enumerated would be not only to let him receive the benefit of an investment made by another, it would allow him a double deduction to which on any rational analysis he is clearly disentitled.

In sum, the aggregate of the seven factors enumerated in *Parsons* v. *Smith* demonstrated the insubstantiality of the contention that the contractors there had made any capital investment in the coal in the ground, that they owned any of the unmined coal. Similar techniques are bound to be helpful in other coal depletion cases, provided that the facts in those

other cases are similarly viewed, namely, to ascertain whether the contractors' claims of having made a capital investment in the unmined coal are real or fictitious. The potential pitfall lies, not in the process of undertaking the overall evaluation, but in concentrating on a particular single factor, in inflating that single factor until it is deemed to have independent significance, and, above all, in using without further analysis facile sounding expressions that have become separated from their original qualifications so that in the end the concept that they originally represented has become not only blurred but distorted.

II. LEGISLATION ENACTED AFTER THE TAX YEARS CONSIDERED IN PARSONS v. SMITH, 359 U.S. 215, AND GOVERNING THE TAX YEARS INVOLVED IN THIS CASE, LIMITS THE DEDUCTION FOR PERCENTAGE DEPLETION IN THE CASE OF COAL LEASES TO THE LESSEE ALONE, AND IN OTHER RESPECTS FURTHER EMPHASIZES THAT ONE WHO HAS SIMPLY CONTRACTED TO MINE ANOTHER'S COAL IS NOT ENTITLED TO THAT DEDUCTION.

The tax years considered in *Parsons* v. *Smith*, 359 U.S. 215, were 1945-1949 for Parsons (Fdg. 5, R. 8-9, No. 218, Oct. T. 1958) and 1944-1947 for Huss (Fdgs. 7-8, R. 29, No. 305, Oct. T. 1958). The tax years involved in the present case are 1955-1957 for Paragon (R. 15, 23, 190-191), and 1954-1956 for its contractors, respondents in No. 237 (R. 1, 6, 190). In the interim new legislation has, in three significant respects, emphasized that the coal mining contractor, the party who has simply undertaken to mine coal owned by another, is not entitled to any deduction whatever for percentage depletion.

First, the present statute specifically emphasizes ownership of the underlying mineral deposit, whereas for the tax years involved in *Parsons* v. *Smith* owner-

ship was mentioned only in the decisions and the aplicable Treasury Regulation.

Second, in the case of coal leases, the statute now grants the deduction for depletion solely and indivisibly to the lessee of the coal, whereas for the tax years involved in *Parsons* v. *Smith* that deduction was required to be equitably apportioned between the coal lessor and the coal lessee.

Third, comparison of the present provisions for capital gains treatment in respect of coal and timber shows that while Congress now defines the term "owner" to include the holder of a contract to cut timber, it does not define that word to include the holder of a contract to mine coal.

The aggregate of these statutory provisions, on which the claim of the respondents in No. 237 must stand or fall—because, after all, it is fundamental that "Whether a deduction from gross income shall be permitted for depletion of mineral deposits, or any interest therein, is entirely a matter of grace," see *Parsons* v. *Smith,* 359 U.S. 215, 219, and cases there cited in note 5—demonstrates even more clearly than was earlier possible that coal contractors have no right whatever to any deduction for depletion.

A. The emphasis in I.R.C. 1954, § 614(a), on ownership of the mineral interest negatives the right of a coal mining contractor to any depletion allowance

The present statutory scheme for depletion allowance emphasizes on its face the lack of any right thereto on the part of the coal mining contractor.

Section 613(a), I.R.C. 1954 (*infra,* p. 2a), states the general rule for percentage depletion as follows:

> "In the case of the mines, wells, and other natural deposits listed in subsection (b), the al-

lowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property * * *."

That is to say, the basic allowance of percentage depletion is keyed to "gross income from the property." And "property" in turn is defined by Section 614(a), I.R.C. 1954 (*infra*, p. 3a), in these terms:

"For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

Hence we ask, just what "separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land" underlying Paragon's leases in this case was owned by its contractors who are respondents in No. 237? The same question can be put in the case of any coal deposit being mined under contract. In each instance, the answer must be, None. The contractors did not own any coal deposit when their operations commenced; they did not acquire ownership in any coal deposit when their contracts, written or oral, were executed; they did not acquire ownership in any coal they mined after that coal was brought to the surface; and consequently by the plain words of § 614(a) they are excluded from Congressional grace of a statutory allowance for a depletion deduction.

We think it proper to point out that, by enacting § 614(a), Congress in 1954 gave legislative sanction to

a definition of property that theretofore had been only a matter of regulation, see Treas. Reg. 111, § 29.23(m)-1(i), and of judicial decision, see the cases emphasizing ownership that we have cited and discussed above under Points IA and IB, pp. 21-27, *supra*.

B. Since 1951, the depletion deduction in the case of coal leases belongs indivisibly to the lessee

For the tax years involved in *Parsons* v. *Smith*, the coal contractors there necessarily rested their claims on the provision for apportionment of the depletion deduction between lessor and lessee, then § 23(m), I. R. C. 1939. Reenacted and slightly changed in language as § 611(b)(1), I.R.C. 1954 (*infra*, p. 1a), there is still such an apportionment in respect of oil, gas, and most other minerals. But, in the case of coal since 1951 (and of domestic iron ore since 1964), the situation has been radically altered by legislation that the courts appear to have ignored, reviving in the process an attitude of "indifference, if not contempt" towards statutory enactments that Roscoe Pound decried over half a century ago. Pound, *Common Law and Legislation*, 21 Harv. L. Rev. 383 (April 1908).

Even since 1951, with respect to taxable years ending after December 31, 1950, the lessor of coal lands who is neither a co-adventurer, partner or principal in the actual mining of the coal has been accorded capital gains or losses treatment in respect of his royalties, and in return for that boon he is denied any allowance for percentage depletion.

This provision was first introduced by Section 325(b) of the Revenue Act of 1951 (Act of Oct. 20, 1951, c. 521, 65 Stat. 452, 501-502), amending § 117(k)(2), I.R.C. 1939; later, in 1954, in order to obviate the decision in

Island Creek Coal Co., 30 T.C. 370, sublessors of coal were included as beneficiaries, and for the years here in question (prior to its amendment by § 227 of the Revenue Act of 1964 [Act of Feb. 26, 1964, Pub.L. 88-272, 78 Stat. 19, 97] to include domestic iron ore), it read in respect of the point now pertinent, following the sentence granting capital gains treatment, as follows (Sec. 631(c), I.R.C. 1954, *infra* at p. 5a):

> "Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal."

Consequently, when Sections 611(b)(1) and 631(c) of the 1954 Code (*infra*, pp. 1a, 4a) are read together, as of course they must be (e.g., *Duparquet Co.* v. *Evans*, 297 U.S. 216, 218; Cardozo, J., in *Panama Refining Co.* v. *Ryan*, 293 U.S. 388, 433, 439), there is no longer any depletion deduction to be "equitably apportioned between the lessor and lessee," for the controlling reason that the lessor of coal is no longer entitled to percentage depletion. Congress amended the Code, in the face of the loss of revenue that the amendment occasioned, because the coal lessor was at a disadvantage under the percentage depletion method, even with the increase in the annual percentage in the case of coal from 5 per cent to 10 per cent that was effected by Section 319(a) of the Revenue Act of 1951 (65 Stat. at 497), amending § 114(b)(4)(A)(ii), I.R.C. 1939. See H.R. Rep. 586, pp. 31-32; Sen. Rep. 871, Part 1, pp. 42-43; Sen. Rep. 871, Part 2, pp. 43-45, all 82d Cong., 1st sess. The 10 per cent figure is now in § 613(b)(4), I.R.C. 1954 (*infra*, pp. 2a-3a).

The Senate Committee in 1951 was at pains to point out that the provisions for capital gains treatment in

lieu of percentage depletion did not apply to a lessee. Sen. Rep. 871, Part 1, 82d Cong., 1st sess., p. 43.

It must therefore be accepted as basic that, since 1951, the lessor of coal lands has been placed on a footing wholly different, with respect to depletion allowance, from that of the lessor of oil and gas lands. It follows that the decisions in this Court, which prior to *Parsons* v. *Smith* dealt almost exclusively with the treatment to be accorded the fractionalization of leasehold interests in oil and gas, under Section 23(m) of the 1939 Code and under identical or substantially identical predecessor provisions, cannot be mechanically applied to what is now the very different situation of the depletion allowance in respect of coal.

Since, therefore, the coal lessor is no longer entitled to percentage depletion, and since there is no affirmative statutory warrant whatever for the contractor to claim depletion, there is nothing now to be apportioned, and all percentage depletion belongs indivisibly to the lessee. Accordingly, the lessee is no longer obliged to share his allowance with anyone.[7]

The foregoing circumstances completely undercut any contention by a mere mining contractor that he is entitled to percentage depletion, a conclusion in which we are reinforced by the efforts made by the

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[7] The lessee computes his percentage depletion on his gross income from the mining property, but must, for that purpose, exclude from such gross income the amount of any rents or royalties paid in respect of the property. Section 613(a), I.R.C. 1954, *infra*, p. 2a (formerly § 114(b)(4)(A), I.R.C. 1939). To that extent his status as a lessee diminishes his allowable deduction for depletion. But since 1951 the lessee of coal lands need no longer divide depletion *qua* depletion.

present contractors to assimilate themselves to the status of lessees who participate in mining the coal.

They say (Br. Op. No. 237, p. 4) that "Paragon entered into oral leases with a number of operators," and indeed the court below made precisely the same assertion (R. 254). But, despite the unanimity with which the operators, who in 1958 had sworn to the terms of "contracts" (R. 231-246), swore in 1961 that they had "leases" (see pp. 96-97 below for record references), the Tax Court disbelieved them, and found (R. 219) that Paragon never "assigned or sublet its leases" and that its contractors "have not acquired any interest in the coal by purchase or lease from the landowners or their lessees."

In short, there is no basis whatever, either generally or else specifically on the findings in this case, for any contention that one who merely contracts with a lessee of coal lands to mine coal on the leased property can somehow bring himself within the term lessee so as to share in what since 1951 has been a depletion allowance indivisibly granted to the lessee.

It is true that the committee reports dealing with the 1951 coal amendments neither mention nor discuss the question of the coal mining contractor's right to depletion. They could not have done so, because that problem had then not yet arisen in the courts.

It was first mentioned inside the then Bureau of Internal Revenue in March 1950. See G.C.M. 26290, 1950-51 Cum. Bull. 42. The Revenue Act of 1951 was signed on October 20, 1951. The first Tax Court ruling that granted any share in the percentage depletion allowance was promulgated over a year later, on November 21, 1952. *James Ruston*, 19 T.C. 284. And

the first court of appeals ruling allowing the contractor any percentage depletion—and reversing the Tax Court in the process—was not published until April 9, 1954. *Commissioner* v. *Gregory Run Coal Co.,* 212 F. 2d 52 (C.A. 4), certiorari denied, 348 U.S. 828.

Turning to the Internal Revenue Code, it appears that the words "economic interest" were first used there in connection with capital gains treatment for timber in 1944. See § 127(a) of the Revenue Act of 1943 (Act of Feb. 25, 1944, c. 63, 58 Stat. 21, 47), adding subsection (k)(2) to § 117, I.R.C. 1939. The same words were first applied to minerals by § 325(b) of the Revenue Act of 1951 (65 Stat. at 501), amending § 117(k)(2), I.R.C. 1939, to include coal. Plainly, then, the framers of the 1951 coal amendments could not have been expected to anticipate distortions of the economic interest concept that were not articulated until several years later.

In any event, even in the absence of the foregoing perfectly understandable explanation for the failure of any Congressional committee to discuss the coal contractors' claim to depletion in 1951, before that claim had been given serious countenance anywhere, the terms of the Code governing the present case are so clear that legislative comment thereon, serving only to repeat the obvious, is quite unnecessary. For, like *Greenwood* v. *United States,* 350 U.S. 366, 374, "this is a case for applying the canon of construction of the wag who said, when the legislative history is doubtful, go to the statute."

C. Since 1951, the distinctions made in the Internal Revenue Code between lessors, sublessors, lessees, and holders of contract rights to cut demonstrate the Congress never intended the holder of a contract right to mine coal to obtain any deduction for depletion

Finally, the restatement in the 1954 Internal Revenue Code of the 1951 coal amendments emphasizes even more strikingly the Congressional intent not to allow any percentage depletion to taxpayers who simply have contracts to mine coal.

Section 117(k)(1) of the 1939 Code, which, as has been seen, was added in 1944, became § 631(a) of the 1954 Code. Section 117(k)(2) of the 1939 Code, which was similarly added in 1944, was amended in 1951 to include coal and to deny the coal lessor depletion in return for capital gains treatment of his royalties; thereafter, in 1954, § 117(k)(2) was divided. The timber provisions became § 631(b) (*infra,* p. 4a), while the coal provisions became § 631(c) (*infra,* p. 4a). (In 1964, the latter subsection was expanded to include domestic iron ore as well as coal, see p. 5a, *infra.*)

These subsections, § 631(b) and § 631(c), reveal significant differences. The last sentence of the timber subsection, Section 631(b), states:

> "For the purposes of this subsection, the term 'owner' means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber."

But the coal subsection, Section 631(c), provided prior to the 1964 amendments that "the word 'owner' means any person who owns an economic interest in coal in place, including a sublessor."

These distinctions, which are inherently important, become even more striking when read in the light of the indisputable fact that while coal deposits, like other minerals, are subject to percentage depletion, timber resources are not, and never were. Sec. 631(b), I.R.C. 1954; §§ 114(b)(3) and (4), I.R.C. 1939.

That is to say, while Congress now defines the term "owner" to include the holder of a contract to cut timber, it does not define that word to include the holder of a contract to mine coal. For timber, which is not subject to percentage depletion, it is sufficient to own "an interest in such timber"; for coal, which is subject to percentage depletion, it is necessary to own "an economic interest in coal in place."

It is true that the timber subsection, § 631(b) of the 1954 Code, does not and did not logically belong under and with other provisions dealing with depletion, since it dealt only with capital treatment of income; but the difference in language in successive subsections, § 631 (b) concerning timber and § 631(c) dealing with coal, cannot be ignored, and it is moreover significant that when the latter section was amended in 1964 to include domestic iron ore along with coal, Congress retained the earlier language so as to make the amended section repeat the necessity of owning "an economic interest in coal or iron ore in place" (*infra* at p. 6a)—and did not include the holder of a contract to mine coal or iron ore in its definition of "owner."

In our view, therefore, the expression in force for the tax years here in question, "economic interest in coal in place"—which, interestingly enough, was only the third time that the words "economic interest" had ever appeared in the internal revenue laws, the first

being in 1944, in connection with timber, and the second in 1951, relating to both timber and coal—the quoted expression plainly involves an incorporation of the "economic interest" concept in the limited and restricted sense that it was first expounded by the Court in *Palmer* v. *Bender* and *Bankline Oil*, in the limited and restricted sense that from *Bankline* it was copied into and still remains in the Treasury Regulations, and in the limited and restricted sense that it was restated and reaffirmed in *Parsons* v. *Smith*.

It follows that, when the 1954 Code is read with regard to its terms rather than in the light of preconceived notions drawn from other provisions, the conclusion is inescapable that Congress never intended to grant even a share of the allowance for percentage depletion to a taxpayer who had only a contract to mine coal in which he had no ownership or other capital investment.

We hope that the Court will not deem the foregoing treatment of the depletion provisions of the current Internal Revenue Code to be either labored or unduly long. But we felt bound to cover the matter in detail, for, as the opinion under review (R. 252-255) indicates, the court below undertook to adjudicate rights to a statutory deduction without once citing, much less discussing or even quoting, the statutory provisions on which that deduction rested. And, in the process, it allowed the deduction for percentage depletion to a coal contractor, who is not only not named in the Code as the beneficiary of such a deduction, but is by the clearest kind of statutory implication denied any right whatever thereto.

III. THE DECISION UNDER REVIEW, WHICH ALLOWED DEDUCTION FOR PERCENTAGE DEPLETION TO PARTIES WHO SIMPLY CONTRACTED TO MINE PARAGON'S COAL, REACHED ITS RESULT THROUGH THE APPLICATION OF SEMANTICIZED FICTIONS THAT DISREGARDED PARSONS v. SMITH, 359 U.S. 215, AND DISREGARDED AS WELL THE APPLICABLE PROVISIONS OF THE INTERNAL REVENUE CODE AND OF THE REGULATIONS THEREUNDER.

A. The decision under review disregarded Parsons v. Smith and this Court's emphasis there and in other cases on ownership representing a capital investment in the mineral in the ground as the criterion of entitlement to the deduction for depletion.

As we have said, *Parsons* v. *Smith,* 359 U.S. 215, 220, unanimously reaffirmed the proposition that "the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset." *Accord, United States* v. *Cannelton Sewer Pipe Co.,* 364 U.S. 76, 86: "Depletion * * * is an allowance for the exhaustion of capital assets."

Here, as in *Parsons* (359 U.S. at 224), the mining contractors "do not show or suggest that [they] actually made any capital investment in the coal in place, or that the landowners were to or actually did in any way surrender to [the contractors] any part of their capital interest in the coal in place. [The contractors] do not factually assert otherwise. Their claim to the contrary is based wholly upon an asserted legal fiction. As stated, they claim that their contractual right to mine coal from the designated lands and the use of their equipment, organization and skills in doing so, should be regarded as the making of a capital investment in, and the acquisition of an economic interest in, the coal in place." But while this Court in *Parsons* decided that (p. 225) "that fiction cannot be indulged here," the court below revived it, with the result that,

to use the Commissioner's language (Mem. Op. 3), "the decision of the court of appeals is basically in conflict with *Parsons.*"

We think that, without in any sense even summarizing the extended discussion in Point I (*supra,* pp. 20-58), we can best document what the Commissioner characterized as "the clear error of the decision below" (Mem. Op. 3) by quoting in order the several factors listed in *Parsons* (359 U.S. at 225) as negativing the fictitious assertion made by the contractors there, and then showing how many of those factors were likewise present here only to be disregarded by the court below.

1. *The contractors' investments were in their equipment, all of which was movable—not in the coal in place.* In the present case also, the mining contractors provided their own mining equipment (R. 213-214), on occasion acquiring it from predecessor contractors (R. 212). Contractors who quit took their equipment with them unless it was subject to a lien (R. 215). The contractors' investment was in their equipment, roads, and buildings (R. 216). They acquired no legal title to the coal in place (R. 216, 222), nor did they acquire any interest in the coal by purchase or lease from the landowners or their lessees (R. 219). They paid nothing for the coal (R. 221, 222), and indeed most of the contractors "disclaim any capital investment in the coal in place—the unmined coal" (R. 222).

Plainly, therefore, none of Paragon's contractors made any capital investment in the coal in place—the factor that under *Parsons* v. *Smith* and the earlier cases here on which *Parsons* rested is the prime requisite for entitlement to the deduction for percentage depletion.

2. *The contractors' investments in equipment were recoverable through depreciation—not depletion.* Paragon's contractors invested only in equipment, roads, and buildings; see references just cited. They took and claimed tax depreciation on their equipment and other assets (R. 212), all of which the Tax Court accordingly characterized as "depreciable equipment" (R. 221, 224).

Thus Paragon's contractors are in process of recovering their entire capital investment. Consequently, to allow these contractors a deduction for depletion in addition to their deduction for depreciation, as the court below did, would be to let them recover in addition for the exhaustion of a further capital investment that they never made.

3. *The contracts were completely terminable without cause on short notice.* While, for reasons set forth at greater length above, pp. 51-53, we believe that a nonterminable contract to mine coal belonging to another does not and can not of its own force transfer to the contractor any capital interest in that coal while it is still in the ground, we are confident that an objective view of the record here will show that Paragon's contracts with its mining contractors were, in fact and in law both, terminable by either party at any time; and that the Tax Court's failure so to find was a consequence of that tribunal's not attaching the proper legal significance to sworn written admissions binding all the respondents in No. 237, which clearly established the mutual terminability of the contracts.

First. Although the Tax Court found (R. 215, 220-221) that nothing was said about the right to terminate when the agreements were made, it pointed out (R. 223-224) that "Paragon could not give an absolute

nonterminable right to mine to exhaustion in view of the landowner's reserved rights under the Paragon lease to terminate in the event of noncompliance with the terms of the lease." Accordingly, it went on to say (R. 224) that "While we cannot find that the right to terminate was specifically mentioned when the agreements were made, neither can we conclude that the agreements were nonterminable."

Passing the point that in the absence of a conclusion that an agreement was nonterminable it was, necessarily, terminable, we are prepared to demonstrate that, even though the question of the terminability or otherwise of Paragon's oral contracts was the most sharply contested testimonial issue at the trial in the Tax Court, that tribunal's conclusions on the terminability issue are, insofar as they represent findings of fact, clearly erroneous—because they disregarded sworn written statements executed a year and a half before the Tax Court proceeding were filed.

Second. Since, under § 7482(a), I.R.C. 1954, decisions of the Tax Court are reviewable on the same footing as non-jury cases tried in United States District Courts, see *Commissioner* v. *Duberstein*, 363 U.S. 278, 291, the applicable standard here is the "clearly erroneous" test of Rule 52(a), F. R. Civ. P., with its authoritative gloss (*United States* v. *United States Gypsum Co.*, 333 U.S. 364, 395) that "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." Judged by that standard, the Tax Court was mistaken, particularly since its finding on the present issue rested on an inadequate evidentiary concept.

Third. In Exhs. 86 and 87, G. Wesley Merritt, one of the respondents in No. 237, twice stated under oath (R. 236, 244) that

> "The contract specified the right of termination by either party at any time, but the question has never arisen between the partners and Paragon."

It is true that both documents were offered and admitted for purposes of impeachment only (R. 161). But this reflected too limited a view of their evidentiary force. Both documents were independently probative as admissions, not simply because they were presented to the Commissioner's subordinates in this very matter of the depletion claims of the partners constituting Kyva and Standard Smokeless, but primarily because they were sworn to by one who was a party to the petition brought against the Commissioner in the Tax Court. 4 Wigmore, *Evidence* (3d ed. 1940) § 1048. Both exhibits were therefore independently admissible for all purposes—once their authenticity was established, and we do not understand that to be questioned—and they would have been thus admissible even if the affiant had never been adduced as a witness by either side.

Moreover, since G. Wesley Merritt was a member of both partnerships, Kyva and Standard Smokeless, and was acting within the scope of his authority for the benefit of both, *viz.,* seeking to reduce their respective tax liabilities, his admission binds all of his partners. 4 Wigmore, *supra,* § 1078, esp. at p. 126. Those partners include all of the respondents in No. 237.

G. Wesley Merritt made oath to both Exh. 86 and Exh. 87 on May 19, 1958 (R. 237-238, 245-246). The several petitions of the respondents in No. 237 were

filed in the Tax Court on November 23, 1959 (R. 1 for Docket No. 84122; see unprinted record for Dockets No. 84123-84126). The several mining contractors' testimony that the question of termination was never discussed (R. Lee Merritt, R. 140; G. Wesley Merritt, R. 147; Watson, R. 170, 172) was not given until November 14, 1961.

We submit that the *ante motam litem* affidavits filed with the Internal Revenue Service in this very matter are so clearly more credible than the oral testimony to the contrary given three and a half years later, after the cause was being actively litigated, that the Tax Court's finding, which is based on the latter, must be regarded as "clearly erroneous"—particularly since that Court's view that the affidavits had only impeaching value cannot be supported.

Fourth. The transition in G. Wesley Merritt's sworn assertions regarding terminability reflects a transition in the decisional law laid down by the court below.

(i) In May 1957, in *Stilwell* v. *United States*, 152 F. Supp. 111 (W.D. Va.), the district court found that "The contract entered into between plaintiffs and Paragon was terminable at the will of either party" (Fdg. 14, 152 F. Supp. at 113). The court below, disregarding that finding, said in December 1957 that the contract was not terminable. *Stilwell* v. *United States*, 250 F. 2d 736, 739 (C.A. 4).

(ii) Exhibits 86 and 87 were executed in May 1958 (R. 237-238, 245-246).

(iii) In April 1959, this Court in *Parsons* v. *Smith*, 359 U.S. 215, 225, in the course of dispelling the fiction that one who mines coal under contract and invests in

mining machinery somehow acquires thereby a depletable capital interest in the coal in the ground, enumerated seven factors, of which terminability was only one.

(iv) But in December 1959, when the court below proceeded to apply the *Parsons* doctrine for the first time, in *United States* v. *Stallard,* 273 F. 2d 847 (C.A. 4), it rested its decision on the single factor of terminability to the virtual exclusion of all else, and that decision has been so interpreted since. See *infra,* pp. 90-94, and especially *Elm Development Company* v. *Commissioner,* 315 F. 2d 488, 490-491.

(v) G. Wesley Merritt testified in the Tax Court on November 14, 1961 (R. 146; Tr. 914, 1042).[8]

The foregoing chronology illuminates the conversion of G. Wesley Merritt.

When, in May 1958, he set forth the terms of his and his partners' contracts with Paragon in detail (R. 235-236, 243-244), and made oath (R. 236, 244) that "The contract specified the right of termination by either party at any time, but the question has never arisen between the partners and Paragon," he swore truthfully. That was before terminability had assumed its later significance in the decisional law. But when, in November 1961, he testified that termination was never discussed, he was plainly endeavoring to swear up to the headnote in *United States* v. *Stallard,* 273 F. 2d 847 (C.A. 4), decided in December 1959. His subsequent efforts to "explain" the earlier affidavits, see R. 156-161, simply reflect the classic symptoms of a wit-

[8] "Tr." refers to the unprinted transcript of testimony in the Tax Court, the pages of which are indicated by "fol." in the printed record here.

ness who has been impaled on a disremembered document.

Accordingly, on the whole record, it is plain that, if the matter is material as a matter of law, G. Wesley Merritt and his partners had contracts with Paragon that were terminable by either party at any time.

Fifth. The record shows that many of Paragon's contractors quit at will (R. 212, 213, 215, 223), a finding consistent only with G. Wesley Merritt's earlier sworn statements on behalf of himself and the other respondents in No. 237 (R. 236, 244) that the contracts were mutually terminable at any time.

Since, therefore, the contractors could quit, i.e. terminate, at will, so could Paragon, for as a matter of State law, it is plain that if a contract is at the will of one party, it is at the will of both. *Cowan* v. *Radford Iron Co.,* 83 Va. 547, 551, 3 S.E. 120, 122; *Eason* v. *Rose,* 183 Va. 359, 364-365, 32 S.E. 2d 66, 68-69; *Shorter* v. *Shelton,* 183 Va. 819, 824, 33 S.E. 2d 643, 645-646; 1 Minor, *The Law of Real Property* (Ribble's 2d ed. 1928) § 357. We think it plain that, whatever the Federal tax consequences, the operation and construction of the contracts here cannot be governed otherwise than by resort to State law, here the law of Virginia, and we fail to grasp the relevancy of the Oklahoma diversity case resting on estoppel that was relied on by the court below (R. 255) in its effort to negative mutuality here. *Phillips Petroleum Company* v. *Buster,* 241 F. 2d 178 (C.A. 10), certiorari denied, 355 U.S. 816. Neither do we perceive the relevancy of the other decision cited below (R. 255), a South Carolina diversity case turning on actionable libel and on what aspects of an action for damages arising out of a terminated contract of employment

should have been submitted to the jury. *Jack's Cookie Company* v. *Brooks,* 227 F. 2d 935 (C.A. 4), certiorari denied, 351 U.S. 908.

4. *Paragon as lessee did not agree to surrender and did not actually surrender to the mining contractors any capital interest in the coal in place.* The Tax Court found (R. 211) that "Paragon acquired by assignment written leases on the coal in and underlying the land here involved in Buchanan County, Virginia, which leases required the lessee to mine either all or 85 per cent of the minable coal in and underlying the tracts under lease"; that (R. 211) "Paragon assumed all the obligations of the lessees under the leases, and was obligated to pay annual minimum royalties, and land taxes"; that (R. 214) "The contractor did not assume any of Paragon's obligations under its leases and paid no royalties or taxes on the property or the mineral interest"; that (R. 216, 222) the contractors acquired no legal title to the coal in place; that (R. 219) they acquired no interest in the coal by purchase or lease from the landowners or their lessees; that (R. 221, 222) the contractors paid nothing for the coal; that (R. 222) most of the contractors "disclaim any capital investment in the coal in place—the unmined coal"; and that (R. 222) "Paragon did not intend to nor did it actually surrender any capital interest in the coal in place to the contractors."

Not only is the last quoted finding on lack of surrender fatal to the contractors' contentions as a matter of Federal law, but the totality of the findings just summarized has significant consequences as a matter of State law.

(i) Under Virginia law (Va. Code § 58-774, *infra,* p. 7a), when the ownership of the surface and of the

underlying coal, are divided, the tax authorities are required to ascertain "the estate of each and the relative fair market value of their respective interests." Yet here the only taxes on the coal in the ground were paid by Paragon and not by its contractors (R. 211, 214).

(ii) As a matter both of state and general law (13 *Michie's Jurisprudence of Virginia and West Virginia* 25-26 [Mines and Minerals, § 14]; *Bankers Pochahontas Coal Co.* v. *Central Pochahontas Coal Co.*, 113 W. Va. 1, 166 S.E. 491; see *Browning* v. *Boswell*, 215 Fed. 826, 835 (C.A. 4), *semble*), leases such as Paragon held that required it "to mine either all or 85 percent of the minable coal in and underlying the tracts under lease" (R. 211), constituted an actual sale to Paragon of the coal in the ground.

That is to say, Paragon as a matter of State law had all (or at the very least a most substantial portion) of the property in the coal in the ground, and duly paid real estate taxes on that property, while the contractors as a matter of State law had no property interest in the coal in the ground and by their conduct of not paying taxes on that coal disclaimed ownership therein. Of course those circumstances are not conclusive; it is far too late in the day to urge that Federal taxation is governed by State doctrines of property; but when parties such as the present contractors in effect represent to the State that they do not own sufficient property interests in unmined coal to be liable for real estate taxes thereon under a State statute that requires the ascertainment of "the estate of each and the relative fair market value of their respective interests" in "the coal * * * under the surface" (Va. Code, § 58-774, *infra*, p. 7a), while simultaneously repre-

senting to the United States that they have a sufficient property based on "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land" (§ 614(a), I.R.C. 1954, *infra*, p. 3a) to be permitted to deduct from their Federal taxes for depletion of that property; one may, at the very least, raise both eyebrows and make searching inquiry as to how or when they obtained their asserted property interest.

Here, as before (*supra*, pp. 69-70), the contractors' asserted property interest in the unmined coal is purely fictitious: No capital assets belonging to the contractors were in any way exhausted or even impaired in the course of the mining process.

5. *The coal at all times, even after it was mined, belonged entirely to Paragon, and the mining contractors could not sell or keep any of it, but were required to deliver to Paragon all that they mined.* The Tax Court's findings show that all of the coal extracted from Paragon's leased lands by its mining contractors was required to be delivered by them to Paragon exclusively (R. 213, 216, 221-222). Specifically, the Tax Court found (R. 216) that "The contractors sold none of the coal to anyone other than Paragon and were not entitled to do so," and that (R. 216, 222.) "They acquired no legal title * * * to the coal after it was mined."

All of these factors, plainly, are inconsistent with any surrender of capital interest from Paragon to its independent mining contractors by virtue of their mining contracts.

6. *The contractors were not to have any part of the proceeds of the sale of the coal, but, on the contrary,*

they were to be paid a fixed sum for each ton mined and delivered. Here, also, the Tax Court's findings in this case show that (R. 214, 222) the mining contractors were compensated by Paragon for mining its coal at a fixed price, which was determined in advance and not subject to retroactive change, and which was earned when the coal was delivered to Paragon's tipple; and, moreover, that the mining contractors were notified in advance of all price changes, and that these took effect prospectively, so that each contractor knew at all times what he would receive for every ton mined, though not what he might receive for coal as yet unmined. Accordingly, it was Paragon and not the contractors who took the risk of market changes occurring after mining.

As the Tax Court said (R. 222), "the contractors had no interest in the coal legally or otherwise after they had delivered it to Paragon. They were paid a fixed price per ton delivered and had no knowledge or interest in the price that Paragon received from the sale of the coal to the consumer. While there is some evidence that the amount paid by Paragon fluctuated somewhat with extended changes in the market price of coal and changes in labor costs, there is no evidence that the amount paid by Paragon was directly related either to the price it was getting for the coal or to the sales price of a particular contractor's coal, and the amount was apparently changeable at the will of Paragon."

Again, these facts require the conclusion that it was Paragon rather than the contractors who had every bit of property interest in the capital assets that were being depleted by the mining operations.

7. ***The contractors thus agreed to look only to Paragon for all sums to become due them under their contracts.*** This final factor from the listing in *Parsons* is also present here, as the Tax Court's finding shows (R. 216):

> "The contractors completed their obligations under the contracts by delivering the coal to Paragon's tipple and thereupon became entitled to their compensation for mining the coal by virtue of Paragon's personal covenant to pay them so much per ton. The contractors were not concerned with the sales price Paragon received for the coal."

The Tax Court further said, following the passage quoted under the previous heading, that (R. 222) "It is also undisputed that the contractor knew the fixed sum he would receive before he delivered the coal. In other words, the contractor had to rely on the personal covenant of Paragon for payment for his services rendered in producing the coal."

Here also, the very specific findings that have been quoted negative any vestige of capital investment in the unmined coal on the part of the contractors.

The foregoing discussion completes the enumeration of the seven factors canvassed in *Parsons* v. *Smith*, 359 U.S. at 225. In the present case there is a further factor, pointing in the same direction as all of the others, namely, the detailed control that Paragon exercised over its contractors' mining operations. To that we turn:

8. *Paragon's rigid control over the actual mining operations is consistent only with its ownership of the coal in the ground, and is utterly inconsistent with the notion that the contractors had any property interest whatever in such unmined coal.* The Tax Court found (R. 214-215) that Paragon selected an engineer, who was paid by the mining contractors, and who then on Paragon's behalf directed them in detail how and where to mine, and as to what pillars they could or could not remove. It found further (R. 215-216, 222-223) that the changes that were thus directed in the course of the mining operations were not predictable in advance, and that this made it impossible to assign to any contractor at the outset any specific area that he could mine to exhaustion.

If the mining contractors had actually owned any capital interest in the coal in the ground, it is inconceivable that they would have submitted to such restraints in dealing with what on their legal theory was their own property—even though, with questionable regard to consistency, they disclaimed any capital investment in the unmined coal (R. 222). But the answer to this speculation, very plainly, is that none of the contractors had, in fact or in law, any property interest in the unmined coal in the ground; and so the Tax Court found and held (R. 216, 221-222).

Indeed, all of the factors discussed above (other than that of terminability) demonstrate such a complete bundle of property rights by way of capital investment in the coal in the ground on Paragon's part, and such a complete lack of any property interest whatever in the unmined coal on the part of the contractors, as to lead independently to the conclusion that the mining contractors' rights were subject to termination by

Paragon at the latter's election, and this quite apart from the sworn admissions in Exhs. 86 and 87 that the contracts when made so provided in terms.

By way of summary, then, as this Court said in *Parsons,* 359 U.S. at 225,

> "Surely these facts show that petitioners did not actually make any capital investment in, or acquire any economic interest in, the coal in place, and that they may not fictionally be regarded as having done so."

But the court below, relying on the circumstance (R. 254-255) that "The parties contemplated that the operators would, and the evidence shows that they did, engage in large expenditures of time and money in preparing their respective sites for mining," concluded (R. 255) that "By virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral which brings them within the rationale of *Parsons* v. *Smith,* 359 U.S. 215 * * *."

That is to say, the court below paid only lip service to *Parsons* v. *Smith,* and in its own decision revived the precise fiction that this Court there advisedly refused to indulge. Or, to use the Commissioner's language (Mem. Op. 3), "the decision of the court of appeals is basically in conflict with *Parsons,*" which "presented the same issue on substantially similar facts" (Mem. Op. 2).

B. The decision under review likewise disregarded the provisions of the 1954 Internal Revenue Code and of the regulations thereunder that demonstrate in unmistakable terms the lack of entitlement to any deduction for depletion on the part of persons who contract to mine another's coal.

There is no need even to summarize here the detailed demonstration already made in Point II, *supra*, pp. 56-58, that under the provisions of the Internal Revenue Code of 1954 there is not even a vestige of statutory language affirmatively granting any part of the depletion allowance to a taxpaper who has simply made a contract to mine coal belonging to another, and that indeed those provisions by the clearest kind of statutory implication negative any such grant.

Yet, as we have said, the court below held Paragon's contractors entitled to share in the depletion allowance without even citing a single statutory provision (R. 252-255), an omission the more striking since every deduction is under established principles a matter of legislative grace (e.g., *Parsons* v. *Smith*, 359 U.S. 215, 219, and cases cited in note 5), an omission peculiarly remarkable in this case since the capital gains treatment for coal contained in § 631(c), I.R.C. 1954, on which Paragon's argument and brief below relied in such large measure, was reflected in well over half of the Tax Court's opinion, which dealt with the royalty issue—as to which no review was sought by either party—under that very subsection (R. 189 (headnote 1), 193-211).

Similarly, the court below disregarded the applicable regulation, § 1.611-1(b)(1) (*infra*, p. 7a), which provided, in language drawn from *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 367, 368, that "a person who has no capital investment in the mineral deposit * * * does not possess an economic interest merely because

through a contractual relation he posses a mere economic or pecuniary advantage derived from production."

We are not similarly critical in respect of the failure to refer to § 1.611-1(c)(2) of the regulations, *infra,* p. 8a, invoked by the contractors (Br. Op., No. 237, p. 11), which deals with "the case of a lease or other contract providing for the sharing of economic interests in a mineral deposit." That regulation is completely irrelevant here, inasmuch as the Tax Court's findings negative any lease to the several mining contractors, whether by Paragon or anyone else (R. 219), and similarly show (R. 222) that "Paragon did not intend to nor did it actually surrender any capital interest in the coal in place to the contractors."

In short, neither the asserted "leases" nor the actual contracts provided "for the sharing of economic interests in a mineral deposit." Accordingly, there is no need to dwell on the further circumstance that the contractors have no property within the other provision of this regulation, that the deduction for depletion "shall be computed by each taxpayer by reference to the adjusted basis of his property * * *."

C. The decision under review marks a reversion to rulings of the court below antedating Parsons v. Smith that permitted one without any capital investment whatever in the coal in the ground to obtain the benefit of the deduction for depletion none the less.

A series of coal depletion cases in the court below that antedated *Parsons* v. *Smith,* 359 U.S. 215, formulated a concept of depletion quite at variance with what this Court held in *Parsons.* But because those decisions were not specifically disapproved by the *Parsons* opinion, the court below apparently felt free to

recur to their approach, see *Elm Development Company* v. *Commissioner*, 315 F. 2d 488, 490 (C.A. 4), with the result that, in the decision now under review, the *Parsons* rationale was completely abandoned. Accordingly, it will probably be helpful to review the Fourth Circuit's course of decision in coal depletion cases.

The first such ruling was *Commissioner* v. *Gregory Run Coal Co.*, 212 F. 2d 52 (C.A. 4), certiorari denied, 348 U.S. 828, where depletion was first granted to a coal contractor, and where the basic concept of the allowance for mineral depletion was altered. Even the question was stated in terms that reflected the deviation (212 F. 2d at 55):

> "The question involved is whether the taxpayer, who mined the coal under the contracts herein described, as distinguished from the taxpayer, who held the leases on the coal land, had such an *economic interest in the operation* as to entitle it to take the deduction for depletion allowed by the federal statutes."

We have added the italics to emphasize the departure from the requirement, restated in *Parsons*, but going back to *Palmer* v. *Bender*, 287 U.S. 551, 557, and *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366-368, that there must be an economic interest, not in the operation, but in the mineral in the ground which represents a capital investment.

None the less, on the strength of what was said in *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, the court below in *Gregory Run* then allowed the contractor depletion, concluding (212 F. 2d at 61) that "in the pending case the rights of the producers were com-

pletely dependent upon the extraction of the salable product and that consequently they were entitled to share in the benefits of the statute which were designed to give compensation to persons interested in the production of a wasting asset."

To the contrary, as this Court has several times said (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 367; *Parsons* v. *Smith*, 359 U.S. 215, 222), "the phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit."

The court below again allowed a coal contractor to deduct for depletion in *Weirton Ice & Coal Supply Co.* v. *Commissioner*, 231 F. 2d 531 (C.A. 4), in an opinion that emphasized the misconceptions on which that result was rested.

Thus, at p. 534 it said, "It is well established that the purpose of the depletion allowance provisions of the statute was to encourage the explorations of natural resurces which are exhausted upon recovery * * *." It seems a sufficient reply to point out that this Court has found a different purpose (*Parsons* v. *Smith*, 359 U.S. 215, 220):

> "The purpose of the deduction for depletion is plain and has been many times declared by this Court. 'It is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production.' * * * '[The depletion] exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired.' ".

In the *Weirton* case the Court below also said (231 F. 2d at 535): "No stronger proof that Weirton had in effect the right to mine the coal could be found than in its willingness to invest $500,000 in the enterprise." But it is only taxpayers investing in a mineral deposit who are granted a depletion allowance; investment in "the enterprise" is insufficient. Parsons had an investment of well over $200,000 in his machinery (Fdg. 31, R. 21-22, No. 218, Oct. T. 1958), Huss had around $500,000 worth of equipment on the job (Fdg. 21, R. 32, No. 305, Oct. T. 1958), yet neither was held entitled to any deduction for depletion.

In the next depletion case decided by the court below, *Commissioner* v. *Hamill Coal Corp.*, 239 F. 2d 347 (C.A. 4), the same question arose in another context. There the taxpayer was the lessee, and the question was whether its depletion allowance was to be shared with its contractor, Daniel Coal Company. The taxpayer-lessee built the tipple, designated the areas to be mined, paid the contractor an agreed rate for the coal mined regardless of the market price for coal, and mined additional coal by itself after terminating its contract with Daniel. The court below, following its earlier decisions, held that the contractor in those circumstances was entitled to share in the depletion allowance.

Fallacies identical with those previously exposed underlay the result. E.g. (239 F. 2d at 350), "These observations [as to the details of the arrangement] are pertinent but when the whole case is considered they do not justify the conclusion that Daniel had no economic interest *in the enterprise* as that phrase has been interpreted by the Courts." (Our italics.) E.g. (239 F. 2d at 350-351), "In our opinion these condi-

tions created an economic interest in the mineral in place not only in the taxpayer but also in Daniel, both of whom made a substantial investment and took a substantial risk dependent upon the successful sale of the coal." Without repeating, we simply ask, "Substantial investment in what?"

In *Stillwell* v. *United States,* 250 F. 2d 736 (C.A. 4), the court below allowed depletion to one who mined under contract with Paragon, petitioner in the present case, in disregard of specific findings of fact that the contract was terminable at will, and that the contractor bore no risk of fluctuating market prices. Pp. 94-95, *infra.* (One of the appellants there testified as a witness in this case (R. 128) that they never bought any interest in the coal in place.) Both facts found by the district court negatived, in our view, any capital investment on the part of the Stilwells in the unmined coal, however much their contract with Paragon conferred upon them an economic advantage.

It was at that juncture that the *Parsons* and *Huss* cases came here from the Third Circuit; certiorari was sought in both on the footing of conflict with the foregoing line of decision by the Fourth,[9] and the briefs of both sets of petitioners on the merits cited and argued the same Fourth Circuit decisions.

As we have repeatedly indicated, both the reasoning and the result of those decisions were necessarily disapproved by the opinion of this Court in *Parsons* v.

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[9] "The decision of the Court of Appeals below is squarely in conflict with the decisions of the Court of Appeals for the Fourth Circuit" (Pet. 9, *Parsons* v. *Smith,* No. 218, Oct. T. 1958); "The decision of the Court of Appeals is in conflict with the decisions of the Court of Appeals for the Fourth Circuit" (Pet. 10, *Parsons* v. *Huss,* No. 305, Oct. T. 1958).

Smith, 359 U.S. 215. But the *Parsons* opinion did not specifically disapprove those decisions by name, in consequence of which their reasoning has been resurrected, reaching full flowering in the ruling now under review. Accordingly, the depletion cases decided in the court below since *Parsons* v. *Smith* need to be briefly reviewed.

(i) In *United States* v. *Stallard*, 273 F. 2d 847 (C.A. 4), the court below did indeed deny depletion to taxpayers who had mined coal under contracts. But in reaching that decision, the court reduced the seven factors set out in *Parsons*, 359 U.S. at 225 (see *supra*, pp. 48-49) to essentially, the single factor of terminability, saying (273 F. 2d at 852-853):

> "We find no material difference between the circumstances of the Parsons case and those of the case at bar. In both, the claim to a deduction rested upon the contract between the taxpayer and the owner under which the taxpayer agreed to furnish the equipment and mine and deliver the coal to the owner at a fixed price per ton; and the right of the taxpayers to carry on the operation was completely subject to the will of the owner by reason of the right of the owner to cancel the contract at any time without cause on short notice. In view of the similarity of these essentials, the minor differences in the facts of the two cases do not distinguish them in the application of the statute."

(ii) We say, "the single factor of terminability," because the *Stallard* decision was so read by the Tax Court in *Walter Bernard McCall*, 37 T.C. 674, a ruling that came before the court below in *McCall* v. *Commissioner*, 312 F. 2d 699 (C.A. 4). There depletion was also denied to coal contractors, again with heavy re-

liance on the terminability clause in their contracts (pp. 701, 704, 705, 706), although there was much discussion of the issue whether the taxpayer's earlier pre-*Parsons* victory in the Tax Court, *Walter Bernard McCall*, 27 T.C. 133, operated as a collateral estoppel in his favor. In holding that it did not, the court below reasserted the significance of terminability (312 F. 2d at 706):

> "With this review, there can be little question but that the Parsons decision, supra, and the Stallard decision, supra, constituted a marked shift in emphasis, if not in basic law, by the Supreme Court and this Court, respectively, of the circumstances where a depletion deduction could be lawfully claimed. That the earlier Tax Court decision, McCall v. Commissioner, 27 T.C. 133 (1956), as compared to the one appealed here, 37 T.C. 674 (1962), represented a similar shift is equally clear. In the earlier case, the formal findings of fact include mention of the thirty-day cancellation clause, but the opinion may be read in vain to find any discussion of the significance of this fact.[9] In the latter, squarely in reliance on Parsons v. Smith, supra, the terminable nature of Rebecca's interest"—Rebecca Coal Company was a contractor—"was held decisive."

(iii) In *Elm Development Company* v. *Commissioner*, 315 F. 2d 488 (C.A. 4), terms of the mining

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[9] [Footnote in original] "To the contrary, the opinion rested on a different basis, 27 T.C. 133, 136:

"'Among the most important criteria in determining whether an independent contractor possesses a true economic interest or only an economic advantage in the coal which he mines are whether or not he has an exclusive right to mine all of the coal within a given area and whether he must look to a sale thereof for his profit—the price which he receives being dependent upon the market price of the coal when sold.'"

contract plainly negatived any ownership of the coal by the contractor at any time; they read in pertinent part (R. 9a in that case, quoted from C.I.R. Br. 13-14):

> "Title to all coal mined and delivered by the Contractor shall at all times, from the time of its severance until its sale by the Company, remain in the Company and Contractor shall have no interest in the coal or in any proceeds from the sale thereof.
>
> "All obligations of the Company to make payments to Contractor hereunder shall be obligations owed by the Company to be paid out of its funds or assets and Contractor shall have no lien or charge against any of the coal produced by it or against the proceeds from the sale thereof."

The Commissioner accordingly argued (C.I.R. Br. 9-35) that "The Tax Court correctly concluded that Elm Development Company had no investment interest in the coal in place on Lorado's leasehold." But the court below allowed depletion to the contractor none the less, on the ground that the contract was terminable only for its default or lack of profitability to the lessee, concluding (315 F. 2d at 491) that when the contract is not terminable at will or on short notice, "the mining company has been granted a right in the coal in place; that is, the right to mine till exhaustion."

The court below also said (315 F. 2d at 490-491), "We distinguish the instant case from Parsons, Stallard and McCall on the ground of terminability. * * * [The mining company's] right to mine the coal without risk of cancellation is its economic interest in the coal in place. The owner has given up an interest in the coal, his right to mine it himself or to determine whether it is mined and who is to mine it. Where the contract is terminable at will or on short notice the

owner has given up none of his rights in the coal in place. * * *"

These excerpts quite fail to explain either (a) how a nonterminable contract to mine could, in the face of the provisions of that contract quoted above, transfer the lessee's capital investment in the coal in the ground to its mining contractor, or (b) how a nonterminable contract in the terms of that one operates as a surrender of capital interest while a terminable one does not. We submit that no such explanations are available, or can be formulated—unless of course fiction is to be deemed an acceptable substitute for legal reasoning.

(iv) The present case, *Merritt* v. *Commissioner*, 330 F. 2d 161 (C.A. 4), is of course diametrically opposed to everything ruled in *Parsons* v. *Smith*, as the detailed documentation under Point IIIA, *supra*, pp. 69-83, demonstrates.

(v) Finally in *Cooper* v. *Commissioner*, 330 F. 2d 163 (C.A. 4), pending on petition for a writ of certiorari, No. 262, this Term, which was decided simultaneously with and on the authority of the present case, the Tax Court had found as a fact on conflicting evidence that the contractors "have failed to establish by a preponderance of evidence that their rights were not subject to termination by Jewell Ridge [the lessee]." *Raymond E. Cooper*, 39 T.C. 253, 256-257. But the court below none the less reversed, weighed the mass of conflicting evidence on that issue independently, and held that the contractors were entitled to a deduction for depletion.

Or, by way of capsule summary of the Fourth Circuit's post-*Parsons* decisions on coal depletion, that

court has yet to indicate its ungrudging acceptance of the principles expounded in *Parsons* v. *Smith*.

D. The decision under review ignored findings of fact made by the Tax Court, many of them on sharply conflicting evidence.

The course of decision by the court below in coal depletion cases discloses a consistent disregard of findings made by the trier of facts.

(1) *Stilwell* v. *United States*, 250 F. 2d 736 (C.A. 4), reversing 152 F. Supp. 111 (W.D. Va.), where the court below held that certain of the present petitioner's contractors were entitled to share in Paragon's depletion allowance, is one of its earliest decisions that attached controlling significance to terminability (250 F. 2d at 739): "A most important factor is the terminability of the taxpayer's rights." But while stressing that factor, the court below brushed aside, without further review of the evidence, the findings of fact made by the district court. This appears from the following extracts:

(A) *Finding 14, 152 F. Supp. at 113:*	(A) *C.A. 4 opinion, 250 F. 2d at 739:*
"14. The contract entered into between plaintiffs and Paragon was terminable at the will of either party."	"The contract was not terminable by Paragon as long as taxpayers' operations were satisfactory and the coal could be profitably marketed. * * * This is not a case where the contract is clearly terminable at the will of either party * * *"

(B) *Finding 16, 152 F. Supp. at 113:*

"16. Plaintiffs completed their obligation under the contract by delivering the coal to Paragon's tipple and thereupon became entitled to their compensation for mining the coal by virtue of Paragon's personal covenant to pay for such services at the amount per ton previously agreed upon by the contracting parties. Plaintiffs were not concerned with the sale price Paragon received for the coal."

(B) *C.A. 4 opinion, 250 F. 2d 739:*

"This is not a case * * * where the contractor's income is dependent upon the personal covenants of those with whom he has contracted without regard to the price at which the coal is sold."

When the court below said here (R. 255, note 2) that "the *Stilwell* case arose out of the same facts," it did not indicate whether it relied on the facts that the district court found there or on the "facts" that the court of appeals invented there.

(2) In the companion case to the present one, *Cooper* v. *Commissioner,* 330 F. 2d 163 (C.A. 4), pending on petition for a writ of certiorari, No. 262, this Term, the Tax Court specifically found (*Raymond E. Cooper,* 39 T. C. 253, 256-257) that "petitioners have urged that their agreements with Jewell Ridge [the lessee] were not subject to termination on the part of Jewell Ridge. Much evidence, both direct and indirect, was given at the trial of this case which bore upon this question. After considering the evidence, we conclude that the petitioners have failed to establish by a preponderance of the evidence that their rights were not subject to termination by Jewell Ridge."

But the court below had no difficulty in brushing aside that finding in the *Cooper* case in the light of its holding in the present case. It said (330 F. 2d at 164):

"We have concluded, therefore, that upon this record as a whole the court was clearly in error in finding that the petitioners had no economic interest in the coal in place and that their contracts were terminable at will by Jewell Ridge. We see nothing to be gained by a detailed repetition of the facts and the reasons underlying our decision in that case."

(3) In the present case, the court below brushed aside the Tax Court's findings on three significant issues.

(a) *Contract or lease?* (i) The Tax Court's opinion throughout makes it plain to any objective and disinterested reader that (R. 211-212) Paragon "contracted the mining out to various individuals and firms who were to mine the coal at their own expense." The Tax Court spoke of "agreement," "agreements," "contract," and "contracts" at least fifteen times (R. 211-216, 219, 221), and referred to the several respondents in No. 237 as "contractors" or "contractor" no less than 70 times by actual count in the course of its discussion (R. 213-216, 219, 221-224).

The Tax Court specifically noted (R. 219) that Paragon never "assigned or sublet its leases" and further stated (R. 219) that "The contractors here have not acquired any interest in the coal by purchase or lease from the landowners or their lessees * * *."

(ii) But, in the face of those explicit findings, the court below asserted (R. 254) that "Paragon entered into *oral leases* with a number of operators"! (We have added the italics out of sheer amazement.)

The court of appeals' disregard of the Tax Court's findings in this instance is the more inexcusable since the contractors and their witnesses at the trial consistently used the word "lease" in virtually an organ-

ized chorus, either in response to questions framed by their counsel, or else on their own (R. 110, 115, 118, 121, 124, 126, 132, 133, 134, 141, 151, 165, 168, 174, 176, 183, 184, 186). Significantly, one of the contractors who talked about a "lease" admitted that he neither paid for the lease nor paid any rent or royalty thereunder (R. 141); while G. Wesley Merritt, another contractor who talked "lease" (R. 151, 165) had, some years earlier, sworn to documents submitted to the Internal Revenue Service in which he consistently referred, on behalf of all his partners (who together with him constitute the respondents in No. 237), to their agreement with Paragon as a contract and never once called it a lease (R. 231-246).

In other words, the Tax Court, which observed the several contractor-witnesses, disbelieved their conclusory characterization of the arrangements with Paragon. But the court below, notwithstanding, said (R. 254) that "Paragon entered into oral leases with a number of operators."

(b) *Fixed price.* Here is the departure by the court below from the findings made by the trier of facts:

Tax Court (R. 222)	*C.A. 4 (R. 254, 255)*
"While there is some evidence that the amount paid by Paragon fluctuated somewhat with extended changes in the market price of coal and changes in labor costs, there is no evidence that the amount paid by Paragon was directly related either to the price it was getting for the coal or to the sales price of a particular contractor's coal, and the amount was apparently changeable at the will of Paragon."	"Paragon agreed to pay a fixed price at the tipple, but it was understood that the price would, and in fact it did, vary with the market. * * * the operators had a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price."

Whether the restatement effected by the court below was designed to bring the present case more nearly into line with the early pre-*Parsons* Tax Court rulings holding that contracts under which the miner was paid a percentage of the ultimate sales price almost automatically entitled him to the depletion allowance (*supra,* pp. 50-51) would of course be only speculation. But the circumstance that the court below in reversing the Tax Court took such obvious liberties with its findings is not speculation at all, but a demonstrable fact.

(c) *Mining to exhaustion.* (i) In its opinion, the Tax Court detailed how Paragon's engineer directed the contractors' mining, so that one contractor did not break through into the mine of an adjacent contractor, but would be able to pierce the barrier if the adjacent contractor ceased operating (R. 214-216). It found (R. 215) that "The contractors were not obligated to mine any specific amount of coal and were not specifically given the right to mine any particular area to exhaustion.".

Later in its opinion the Tax Court amplified the evidence underlying the quoted finding. It said (R. 222-223):

> "The evidence rather indicates that the contractors were given a general area in which to mine under the supervision of an engineer who was authorized to plan a system of mining for the extraction of all the minable coal in the seam and who was authorized to change the projection of any contractor's mine in order to accomplish this objective. * * * we believe the barriers were shown primarily to prevent adjacent contractors from breaking through into each other's mines and were not intended to specify definite boun-

daries for the areas of coal the contractor was entitled to mine. * * * it could not be determined in advance from just what direction the coal in an area would have to be mined to recover all minable and merchantable coal. But inasmuch as Paragon was obligated under its leases to remove at least 85 percent of the coal, the areas given to a particular contractor had to be and remain flexible."

The Tax Court then continued (R. 223-224):

"The evidence is conflicting as to whether the contractors were given the right to mine a specific area of coal to exhaustion. However, there is very little conflict in the evidence that the contractors were not *obligated* to mine any boundary of coal to exhaustion, and in fact, many of them quit at any time they chose. It seems unlikely that the parties would have contemplated granting the contractor the nonterminable right to mine specific areas to exhaustion without also obligating him so to mine it. Furthermore, Paragon could not give an absolute nonterminable right to mine to exhaustion in view of the landowner's reserved rights under the Paragon lease to terminate in the event of noncompliance with the terms of the lease. While we cannot find that the right to terminate was specifically mentioned when the agreements were made, neither can we conclude that the agreements were nonterminable."

(ii) The court below brushed aside these findings also. It said (R. 255), "We think the Tax Court was in error in concluding that because the oral contracts were silent on the point, the operators did not possess a non-terminable right to mine to exhaustion, especially in the fact of the court's finding of an intent on the part of the parties to the contrary. * * * The fact that the contracts did not fix upon the operators an *obliga-*

tion to mine to exhaustion does not vitiate the binding effect of the intent of the parties to vest in the operators a *right* to mine to exhaustion."

We only ask, In what specific tract, described either by metes and bounds or by natural features, did any particular contractor have such a right when he commenced work? That palpably unanswerable question, we submit, underscores the liberties taken by the court below with the findings made by the trier of facts.

E. The decision under review rests its result on a series of semanticized fictions.

We had supposed that *Parsons* v. *Smith,* 359 U.S. 215, marked the shift from fiction to reality in coal depletion cases. But, in this aspect also, its teaching is not reflected in the decision under review; the opinion below, in no less than three respects, relies on semantic devices.

1. "Paragon's experience was as a processor and seller of coal rather than a producer; furthermore it lacked the capital to go into the producing end of the business" (R. 253). "* * * the operators had a continuing right to produce the coal * * *" (R. 255).

The verb "produce" is pure semantics—or, perhaps more precisely, impure semantics, because that word is demonstrably inaccurate both in fact and in law.

The word "produce" is wrong in fact, because the several contractors simply mined the coal. They did not produce it and Paragon could not produce it. The coal was produced by geologic forces over the centuries.

The word "produce" is doubly wrong as a matter of law.

Paragon was engaged in mining, and it did not cease to be a coal mining concern simply because the persons actually extracting its coal were independent contractors rather than its direct employees. *Qui fecit per alium fecit per se.*

Moreover, under the explicit provisions of I.R.C. § 613(c)(2), as it stood for the tax years here in question (*infra*, p. 3a), "mining" was defined as including "not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product." And "ordinary treatment processes" in the case of coal was further defined in I.R.C. § 613(c)(4)(A), again for the tax years concerned here (*infra*, p. 3a), as including "cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment."

Under the Tax Court's findings concerning Paragon's functions (R. 212, 216),[10] therefore, Paragon was a coal mining company both in law and in fact. It follows that to speak of "producing" coal, and to contrast "producer" with "processor" to Paragon's disadvantage, as the court below did, is to inject an element of verbal obfuscation that inhibits meaningful legal analysis.

2. "Paragon entered into oral leases with a number of operators" (R. 254).

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[10] "Paragon would then clean and size the coal and sell it on the market" (R. 212). "The coal as delivered to Paragon's tipple by the contractors was not in a state which was salable to the consumer but had to be washed, graded, and treated in order to be salable upon the consumer market. All such processing was done by Paragon at its processing plant." (R. 216.)

We have already dealt with the use of the word "lease" by the court below, in disregard of the findings of fact; see pp. 96-97, above. This is actually less an instance of semantics, a device that involves subtle nuances of meaning, than of downright mislabeling, reminiscent of Tom Sawyer's insistence as a matter of principle that the pickax he was finally compelled to use was a case-knife nonetheless. See Pound, *The Spirit of the Common Law* (1921) 166-167.

Wide latitude, of course, is allowed the trier of facts in drawing evidentiary inferences that cannot be stated in absolute terms where determinative features can only be found in "intent"; the classic recent example was the Government's proposal to promulgate principles and presumptions to govern what was and what was not a "gift" for Federal tax purposes. *Commissioner v. Duberstein*, 363 U.S. 278; *United States v. Kaiser*, 363 U.S. 299.

No such latitude, we believe, is available where the point in question is susceptible to more objective evalulation, as here on the issue of contract versus lease. But, to the extent that the trier of facts has any freedom in the present situation, the Tax Court's findings (R. 219) that Paragon's mining contractors received no lease from it or from any other source, whether by sublease or by assignment, are unassailable. Those findings are not "clearly erroneous" on any theory, and hence are safe in this Court from the inverted verbalism with which the court below (R. 254) spoke of "oral leases."

3. "The parties contemplated that the operators would, and the evidence shows that they did, engage in large expenditures of time and money in pre-

paring their respective sites for mining. * * * By virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral which brings them within the rationale of *Parsons* v. *Smith,* 359 U.S. 215 * * *." (R. 254-255.)

Actually, these key passages from the opinion below simply repeat the very semantic device that was scotched by *Parsons,* because they omit the significant qualifications emphasized there, qualifications that the court below prior to *Parsons* had consistently disregarded (pp. 85-89, *supra*).

Parsons, 359 U.S. at 224, disposed of the "asserted legal fiction" that a "contractual right to mine coal from the designated lands and the use of their equipment, organizations and skills in doing so, should be regarded as the making of a capital investment in, and the acquisition of an economic interest in, the coal in place."

Parsons emphasized throughout that the requisite economic interest must represent a capital investment in the coal in the ground, and was at pains to point out that the party asserting such an investment must show a surrender to it of the capital interest in such coal.

In short, the court below brushed aside both the holding and the reasoning of *Parsons* v. *Smith,* and, by resort to the precise semantic fiction that was there expressly and indeed emphatically rejected, has by a species of sleight of hand transformed expenditures under a mining contract into a capital investment in the unmined coal. Therein lies the basic fallacy of the decision under review.

CONCLUSION

The decision below nullifies *Parsons* v. *Smith*, 359 U.S. 215. The judgment below should therefore be reversed, with directions to reinstate the decision of the Tax Court.

Respectfully submitted.

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APPENDIX

STATUTES AND REGULATIONS INVOLVED

1. Sections 611(a) and (b), I.R.C. 1954, as amended, are as follows:

"§ 611. Allowance of deduction for depletion

"(a) General rule.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term 'mines' includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

"(b) Special rules.—

"(1) Leases.—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

"(2) Life tenant and remainderman.—In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

"(3) **Property held in trust.**—In the case of property held in trust, the deduction under this section shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

"(4) **Property held by estate.**—In the case of an estate, the deduction under this section shall be apportioned between the estate and the heirs, legates, and devisees on the basis of the income of the estate allocable to each."

2. Section 613(a), I.R.C. 1954, as amended through 1960, provided as follows:

"**§ 613. Percentage depletion**

"(a) **General rule.**—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section."

3. Section 613(b)(4), I.R.C. 1954, provides as follows:

"(b) **Percentage depletion rates.**—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

* * * * *

"(4) 10 percent—asbestos (if paragraph (2) (B) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite."

4. Sections 613(c)(2) and 613(c)(4)(A), I.R.C. 1954, provided, prior to the 1960 amendments, as follows:

"(c) **Definition of gross income from property.**—For purposes of this section—

* * * * *

"(2) **Mining.**—The term 'mining' includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * *

"(4) **Ordinary treatment processes.**—The term 'ordinary treatment processes' includes the following:

"(A) In the case of coal—cleaning, breaking, sizing, dust allaying, treatment to prevent freezing, and loading for shipment; * * *"

5. Section 614(a), I.R.C. 1954, provides as follows:

"**§ 614. Definition of property**

"(a) **General rule.**—For the purpose of computing the depletion allowance in the case of mines,

wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

6. Section 631(b), I.R.C. 1954, provides as follows:

"§ 631. Gain or loss in the case of timber or coal

* * * * *

"(b) **Disposal of timber with a retained economic interest.**—In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term 'owner' means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

7. Section 631(c), I.R.C. 1954, provided prior to the 1964 amendments as follows:

"(c) **Disposal of coal with a retained economic interest.**—In the case of the disposal of coal (in-

cluding lignite), held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal, the difference between the amount realized from the disposal of such coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal, and the word 'owner' means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determing the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535(b)(6) or section 545 (b) (5))."

8. Section 631(c), I.R.C. 1954, following its amendment by § 227 of the Revenue Act of 1964, provides as follows:

"§ 631. Gain or loss in the case of timber, coal, or domestic iron ore

* * * * *

"**(c) Disposal of coal or domestic iron ore with a retained economic interest.**—In the case of the dis-

posal of coal (including lignite), or iron ore mined in the United States, held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal or iron ore, the difference between the amount realized from the disposal of such coal or iron ore and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal or iron ore. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal or iron ore, and the word 'owner' means any person who owns an economic interest in coal or iron ore in place, including a sublessor. The date of disposal of such coal or iron ore shall be deemed to be the date such coal or iron ore is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535(b)(6) or section 545 (b)(5)). This subsection shall not apply to any disposal of iron ore—

"(1) to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b), or

"(2) to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore."

9. The third paragraph of Section 58-774 of the Code of Virginia provides as follows:

"If the surface of the land is held by one person and the coal, iron and other minerals, mineral waters, gas or oil under the surface be held by another person, the estate of each and the relative fair market value of their respective interests shall be ascertained by the commissioner [of revenue of the respective county]."

10. Sections 1.611-1(b)(1) and 1.611-1(c)(2) of the Regulations under I.R.C. 1954 provide as follows:

"NATURAL RESOURCES

"DEDUCTIONS

"§ 1.611-1 Allowance of deduction for depletion

* * * * *

"(b) Economic interest.—(1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess a mere economic or pecuniary advantage derived from production.

For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders."

* * * * *

"(c) **Special rules**—

* * * * *

"(2) **Leases.**—In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interests in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder."